Private Equity Issues (E) Working Group
Conference Call
February 17, 2015

The Private Equity Issues (E) Working Group of the Financial Condition (E) Committee met via conference call Feb. 17, 2015. The following Working Group members participated: Doug Stolte, Chair (VA); Jim Armstrong, Vice Chair (IA); Cindy Donovan (IN); Ken Abitz (KS); Steve Kerner (NJ); Mark McLoad (NY); and Frank Stone and Eli Snowbarger (OK).

1. Adopted its 2014 Fall National Meeting Minutes

Mr. Armstrong made a motion, seconded by Mr. Kerner, to adopt the Working Group’s 2014 Fall National Meeting minutes. The motion passed unanimously.

2. Voted to Expose Revised Proposed Changes to the Financial Analysis Handbook

Mr. Stolte reminded the Working Group that the proposed changes to the Financial Analysis Handbook represent a new section, and its primary objective is to assist the analyst in thinking about different risks that can be associated with a change in control. He stated that many of the issues the Working Group discussed that are related to private equity can also be applicable to other acquiring parties, and that is why the guidance is not specifically directed at private equity. Mr. Stolte noted, however, that he believes the guidance captures many of the best practices that have been used by states such as New York and Iowa on these specific types of transactions but that subsequent to the 2014 Fall National Meeting, he directed NAIC staff to add new guidance to emphasize two points he heard in the presentation from the U.S. Securities and Exchange Commissioner representative at the Fall National Meeting: 1) issues of high expenses; and 2) the use of near-related parties.

Mr. Stolte requested NAIC staff provide the Working Group with a more detailed summary of the currently drafted guidance, as well as the most recent changes. Dan Daveline (NAIC) summarized the draft guidance, noting many of the same things as Mr. Stolte, but talked through the content and purpose of each of the major sections. This included talking about how the guidance was intended to be qualitative factors for the analyst to consider if there were any material risks that were raised as a result of the proposed transaction. He noted that the draft guidance utilizes the nine branded risk classifications to give the analyst some things to consider when reviewing the proposed transaction. He discussed how some of the guidance and the nine branded risks would apply to many insurers within a holding company system, while other risks—such as credit, market and liquidity—would tend to be the most common risks that could exist within the noninsurers within the holding company system. He noted that the guidance emphasizes that certain investment-related transactions were particularly prone to be subject to excessive expense charges and that the state already has the authority to review and approve or deny such transactions if such risks exists. Mr. Daveline emphasized that the new guidance added since the 2014 Fall National Meeting emphasizes this point, as well as the other point about near-related parties. He stated the remaining guidance focuses on possible stipulations that the state can place upon the approval of the Form A filing, either for a limited period of time or a longer period of time. He noted that after the transaction is approved, either with or without stipulations, the analyst may see risks that suggest the need for the ongoing review or targeted examination procedures related to certain risks. Ms. Donovan made a motion, seconded by Mr. Kerner, to expose the revised proposed changes to the Financial Analysis Handbook for a public comment period ending March 11. The motion passed unanimously.

Having no further business, the Private Equity Issues (E) Working Group adjourned.
GUIDANCE AS EXPOSED

Forms A, B, D, E (or Other Required Information), F and Extraordinary Dividend/Distribution

Forms A, D, E (or Other Required Information) and Extraordinary Dividends/Distributions are transaction specific and are not part of the regular annual/quarterly analysis process. The review of these transactions may vary, as some states may have regulations that differ from these forms.

Form A – Statement of Acquisition of Control of or Merger with a Domestic Insurer

The Insurance Holding Company System Regulatory Act (#440) outlines specific filing requirements for persons wishing to acquire control of or merge with a domestic insurer. Form A is filed with the domestic state of each insurer in the group. Every attempt should be made to coordinate the analysis and review of holding company filings among all impacted states and other functional regulators to avoid duplicate processes. The domestic state or lead state should communicate the filing with all impacted states.

The period for review and action on proposed affiliations for transactions falling under the GLBA is limited to 60 days prior to the effective date of the transaction. Under GLBA Section 104(c)(2), the states have a 60-day period preceding the effective date of the acquisition, change, or continuation of control in which to collect information and take action. Individual state statutes and regulations may or may not impose other time limitations on the review period.

Discussion of Supplemental Procedures for Forms A, B, D, E (or Other Required Information), F and Extraordinary Dividend/Distribution

The analysis of Forms A, B, D, E (or Other Required Information), F and Extraordinary Dividend/Distribution are documented in the separate Holding Company Supplemental Procedures due to the significance of the filings and the timing of these filings.

NOTE: Certain procedures include the 2010 revisions to the Insurance Holding Company System Regulatory Act (#440) and Insurance Holding Company System Model Regulation with Reporting Forms and Instructions (#450). For the states that have not adopted these revisions, the requirements of your own state’s laws and regulations should be applied when reviewing these filings. Changes related to the 2010 revisions are highlighted in the procedure text.

Form A – Statement Regarding the Acquisition of Control of or Merger with a Domestic Insurer

Procedures #1-4 provide instructions to enter and review information in the NAIC Form A database.
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Procedures #5-21 assist the analyst in reviewing the Form A filing for completeness. They guide the analyst through each of the major items of information required by Form A and ask the analyst to document any risks or concerns noted during his/her review of the required information.

Procedures #22-34 assist the analyst in assessing the impact of the acquisition or merger on the domestic insurer and policyholders.

In addition to the supplemental procedures 1-34 as previously described, the analyst may also want to consider certain other qualitative factors when reviewing a Form A application. Most of these factors are intended to suggest the analyst contemplate the broader risks associated with the proposed transaction. Although the concept of identifying the broad risks of the transaction are embedded in many of the previously referenced procedures, in some cases it may be reasonable to approve the transaction, but only if certain conditions are met or agreed to by the applicant.

When considering the following guidance, it is appropriate to first consider the general statutory standards that regulators must apply in consideration of a Form A, namely that:

1) the financial stability of the insurer would not be jeopardized;
2) that policyholders will not be prejudiced;
3) that the acquiring party’s future plans are not unfair and unreasonable to policyholders; and
4) that the transaction is not likely to be hazardous or prejudicial to the insurance-buying public.

Although these are the general statutory standards that apply, the analyst may need to think more broadly when considering whether these standards have been met. The point of this suggestion is to consider all aspects of the financial condition of the acquiring entity including the acquiring entity’s group business model, its strategy in general, and its specific strategy in purchasing the insurer, as well as any assumptions used by the acquiring entity in its evaluation of the benefits of the proposed transaction. Understanding these aspects of the proposed transaction should assist the analyst in reaching a recommendation related to the proposed transaction.

The analyst is already required in other areas of this handbook to consider the prospective risks of any domiciled insurer as they perform their annual analysis and ongoing financial solvency oversight of the insurer. This also includes considering the financial condition of the entire holding company structure as defined within state law and discussed separately within this Section E. Therefore, as the analyst considers the application for change in control, it may be appropriate to consider the following risks of the acquiring entity and the entire group of affiliate insurers and non-insurers under its control:

- **Credit**—Amounts actually collected or collectible are less than those contractually due.
- **Market**—Movement in market rates or prices (such as interest rates, foreign exchange rates or equity prices) adversely affects the reported and/or market value of investments.
- **Pricing/Underwriting**—Pricing and underwriting practices are inadequate to provide for risks assumed.
- **Reserving**—Actual losses or other contractual payments reflected in reported reserves or other liabilities will be greater than estimated.
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- **Liquidity**—Inability to meet contractual obligations as they become due because of an inability to liquidate assets or obtain adequate funding without incurring unacceptable losses.
- **Operational**—Operational problems such as inadequate information systems, breaches in internal controls, fraud or unforeseen catastrophes resulting in unexpected losses.
- **Legal**—Non-conformance with laws, rules, regulations, prescribed practices or ethical standards in any jurisdiction in which the entity operates will result in a disruption in business and financial loss.
- **Strategic**—Inability to implement appropriate business plans, to make decisions, to allocate resources or to adapt to changes in the business environment will adversely affect competitive position and financial condition.
- **Reputational**—Negative publicity, whether true or not, causes a decline in the customer base, costly litigation and/or revenue reductions.

In considering the above, the issues of legal risk and reputational risk are generally well incorporated into the Form A application and its review. Many of the other risks (pricing/underwriting/reserving) tend to be most concentrated in the area of the insurers and therefore in these cases, it is reasonable that the analyst initiate conversations with regulators of existing insurers in the applicant’s group (domestic states or foreign jurisdictions) to determine if there are any concerns in these areas. However, the proposed transaction may put additional pressure on the insurer and the group from the standpoint that it may increase the leverage (operating or financial) which has the potential to increase the risks in each of these areas. The Form A application already contemplates obtaining proforma results for the insurer and the group. As the analyst reviews the proposed transaction, they may want to consider requesting additional information related to such proformas, such as how such results, and perhaps key ratios (e.g. operating or leverage) may look under certain feasible stress scenarios, particularly those that can be the most problematic for the group given its existing products or those included in its proposed business plan. However, stress scenarios should be evaluated in the context of how the company, as currently configured, would perform under the same stress scenarios. This may also be helpful in further assessing credit, market or liquidity risk. The results of such stresses should not be overemphasized, but should be considered when evaluating whether the proposed transaction meets the previously mentioned criteria. Such an analysis may also be helpful in evaluating the strategic risk of the company and the group. However, strategic risk may be difficult to evaluate without additional information beyond the proforma financial statements. This is because the proforma financial statements may not reveal enough information to permit the analyst to evaluate the ability of the group to execute its business plan.

More often, the risks that may be most difficult to discern are those that may exist within noninsurance affiliates because such entities may be unregulated, therefore eliminating the ability to obtain information from another regulator as can be done with insurers. Generally speaking, such noninsurance affiliates will not carry pricing, underwriting and reserving risks because those risks tend to be thought of as insurance risks. Those affiliates may however have other comparable risks, or unrelated risks that may be evident from a review of the proforma information. In particular, something that may not be captured in the proforma information is the other types of risks not already discussed which include or pertains to credit, market and liquidity. For some noninsurance affiliates, these risks can be more pronounced, or at least by comparison to the relative risk from the insurers within the group because state investment laws may serve as a deterrent to excessive amounts of such risks. Consequently, in addition to considering the
information provided in proforma financial statements and even stressed proforma financial statements, the analyst may need to obtain additional information in order to evaluate whether the proposed transaction meets the four previously identified general standards. In order to evaluate credit, market and liquidity risk, the analyst should evaluate the potential enterprise risks posed to the insurer from other non-insurer group members, and may need to request information regarding the investment portfolio of the entire group. In all cases where information is sought relating to non-insurer affiliates, controlling persons and other equity holders, care should be taken to ensure that confidentiality of such information can be appropriately protected.

In some cases, this may require more detailed information regarding investments such as LLCs, equity and other fund holdings and other invested assets (BA for insurer). In cases where the investment portfolio appears to be complex, the analyst may need to consider engaging an investment specialist and actuary to review the entire proposed transaction to determine if the investment strategy and related affiliated agreements are appropriate or not excessively risky for the backing of the insurance contracts from a risk and asset/liability matching perspective, respectively. Such a review would consider equity firm fees and other fee structures charged or to be charged to the insurance company, if any, as well as any proposed or existing similar arrangements between the insurance company and affiliated broker dealers are reasonable. This particular risk is one that can be common in many different types of holding company structures. Because of this, states have the authority within their holding company laws to review and deny transactions which have the potential to excessively charge the insurer for certain services and transactions if the costs are not excessive in comparison to costs for a similar transaction with a non-affiliated entity. For this reason, considering whether such contracts exist and reviewing them prior to agreeing to the proposed Form A may be appropriate. The analyst should also consider reviewing arrangements with parties that are not considered affiliates by definition, but which are parties that seem to be engaging in a manner that is similar to an affiliate. Again, the primary concern is that these arrangements could excessively charge the insurer for certain services, but other concerns can exist such as the appearance of relationships that are used to prevent full disclosure of the entirety of activities within the defined holding company structure. Again, in many cases the primary concerns with a proposed transaction may be derived from the credit, market and liquidity risk of the non-insurers (or related strategic risks), and this type of analysis may be necessary in cases where these risks may pose enterprise risks to the insurer. In many cases, provided the application includes information on the overall investment portfolio, it may be unnecessary to obtain the above type of more detailed information and perform the above more detailed review by an investment specialist. In many cases a 5 year plan of operation being provided can satisfy this requirement. This type of plan can also be helpful in mitigating the need for future detailed information on the group’s investments if investments, reinsurance or other items are not concerning, or do not change materially.

After considering all of the risks of the proposed transaction, the analyst and the state may determine that the proposed transaction either meets the general standards previously referred to, or can be met with the addition of certain stipulations agreed to by the acquiring entity. These stipulations can include things such as the following:

Stipulations for limited period of time
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- Requiring RBC to be maintained at a specified amount above company action level/trend test level because capital serves as a buffer that insurers use to absorb unexpected losses and financial shocks – better protecting policyholders;
- Requiring quarterly RBC reports rather than annual reports as otherwise required by state law;
- Prohibiting the insurer from paying any ordinary or extraordinary dividends or other distributions to shareholders unless approved by the Commissioner;
- Requiring a capital maintenance agreement from or establishment of a prefunded trust account by the acquiring entity or appropriate holding company within the group;
- Enhancing scrutiny of operations, dividends, investments, reinsurance, by requiring material changes in plans of operation to be filed with the Commissioner (including revised projections), which, at a minimum, would include affiliate/related party investments, dividends, or reinsurance transactions to be approved prior to such change; and
- Requiring a plan to be submitted by the group that allows all affiliated agreements and affiliated investments to be reviewed despite being below any materiality thresholds otherwise required by state law. Such review may be particularly helpful to verify there are no cost sharing agreements between the insurer and affiliated entities which are abusive to the policyholders funds.

Continuing stipulations

- Requiring prior Commissioner approval of material arms-length, non-affiliated reinsurance treaties or risk-sharing agreements.
- Requiring notification within 30 days of any change in directors, executive officers, manager, or person in similar capacities of controlling entities, and biographical affidavits and such other information as shall reasonably be required by the Commissioner;
- Requiring the filing of additional information regarding the corporate structure, controlling persons, and other operations of the company;
- Requiring the filing of any offering memoranda, private placement memoranda, any investor disclosure statements or any other investor solicitation materials that were used related to the acquisition of control or the funding of such acquisition.
- Requiring disclosure of equity holders (both economic and voting) in all intermediate holding companies from the insurance company up to the ultimate controlling person or individual, but considering the burden on the acquiring party against the benefit to be received by the disclosure;
- Requiring the filing of audit reports/financial statements of each equity holder of all intermediate holding companies, but considering the burden on the acquiring party against the benefit to be received by the disclosure; and
- Requiring the filing of personal financial statements for each controlling person or entity of the insurance company and the intermediate holding companies up to the ultimate controlling person or company. Controlling person could include for example, a person that has a management agreement with an intermediate holding company.

With respect to the above, although each has its own limitations, they may provide additionally assurances. For example, a capital maintenance agreement has a number of pros and cons, but regardless
IV. Analyst Reference Guide – E. Holding Company System Analysis

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they can simply raise the awareness to the ultimate controlling party of the need to be a good corporate citizen.

Even after the proposed transaction has been approved, or approved with stipulations, it may be appropriate to use existing authority to perform either an annual or otherwise targeted examination of certain risks or use of ongoing (e.g. quarterly) conference calls or meetings to ascertain whether the proposed transaction and the business plan are being executed as anticipated. These are not things that would be done all the time, but only where necessary to give regulators the appropriate comfort level. During such an examination or meeting, the analyst may want to consider (as an example) any of the following procedures, using a specialist where deemed appropriate:

- Examine the insurer and its affiliates to ensure that the investment strategy provides a prudent approach for investing policyholder funds or does not create excessive contagion risk;
- Require ongoing annual stress testing of the insurer and the group in accordance with existing laws and regulations. This includes stress testing not only the investments but also the policyholder liabilities to ensure that the assets and liabilities continue to be properly matched;
- Periodic and possible ongoing review of the investment management and other affiliated agreements, including reviewing the equity firm fees and fee structure charged or to be charged to the insurer, if any, as well as arrangements with intercompany broker to ensure that they continue to be fair and reasonable and examine the flow of funds related to such agreements;
- Coordinate a meeting with multiple regulators and even all states to the extent there is a need for all regulators to better understand the business plan and operations of the group; and
- Coordinate an examination with another regulator of a non-affiliated insurer where the direct writer has ceded a material portion of their risk to a separately controlled insurer.

Detail Eliminated To Conserve Space

Extraordinary Dividend/Distribution

Procedures #1-6 assist the analyst in ensuring that any extraordinary dividend or distribution was approved by all of the appropriate channels, was fair and reasonable, and did not result in inadequate surplus for the insurer.

Alternatively, the proposed additional narrative guidance could be added here to avoid confusing the analyst looking for the brief information (such as the above brief statements on procedures 1-4, 5-21 and 23-34) regarding Form B, D, E, F.
March 11, 2015

Private Equity Issues Working Group
National Association of Insurance Commissioners
Attn: Mr. Dan Daveline
Via Email: DDaveline@naic.org

Re: Comments on Proposed Revisions to Financial Analysis Handbook – Change In Control Applications

The American Insurance Association (AIA) appreciates the opportunity to submit this letter to the Private Equity Issues Working Group, in response to the proposed revised guidance in the Financial Analysis Handbook, relating to review of Change In Control applications. AIA represents approximately 300 major U.S. insurance companies that provide all lines of property-casualty insurance to consumers and businesses across the United States and around the world. AIA members write more than $117 billion annually in U.S. property-casualty premiums and approximately $225 billion annually in worldwide property-casualty premiums.

Our comments are intended to clarify the exposed guidance. The combination of the exposed new language with the existing language sometimes creates ambiguities, so we have provided edits that we hope reflect the intent of the writers. Please contact us with any questions about our suggested changes.

Sincerely,

Phillip L. Carson
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Director of Financial Regulatory Policy

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Such a review would consider the reasonableness of equity firm fees and other fee structures, if any, charged or to be charged to the insurance company, if any, as well as any similar arrangements, proposed or existing similar arrangements, between the insurance company and affiliated broker dealers are reasonable. This is a particular risk that can be common in many different types of holding company structures. Because of this risk, states may need to look to authority within their holding company laws to review and deny transactions which have the potential to excessively charge the insurer for certain services and transactions if the costs are not excessive in comparison to costs for a similar transaction with a non-affiliated entity. For this reason, considering whether such contracts exist and reviewing them prior to agreeing to the proposed Form A, it may be appropriate to consider whether such contracts exist and to review them.

The analyst should also consider reviewing arrangements with parties that are not considered to be affiliates by definition, but which appear to be engaging in a manner that is similar to an affiliate. Again, the primary concern is whether these arrangements could be excessively charging the insurer for certain services, but other concerns can exist such as the appearance of relationships that are used to prevent full disclosure of the entirety of activities within the defined holding company structure. Again, in many cases the primary concerns with a proposed transaction may be derived from the lack of transparency in the credit, market and liquidity risk of the non-insurers.
related strategic risks), and this type of further analysis of these presumably unrelated party transactions may be necessary in cases where these to determine if the risks of the non-insurer, including strategic risks, may pose enterprise risks to the insurer.

In many cases, provided the application includes information on the overall investment portfolio, it may be unnecessary to obtain the above type of more detailed information and to perform the above more detailed review by an investment specialist. In many cases, providing a 5 year plan of operation being provided can satisfy this requirement. This type of plan can also be helpful in mitigating the need for future detailed information on the group’s investments if investments, reinsurance or other items are not concerning a concern, or do not change materially.
Language as Proposed

Requiring a plan to be submitted by the group that allows all affiliated agreements and affiliated investments to be reviewed despite being below any materiality thresholds otherwise required by state law. Such review maybe particularly helpful to verify there are no cost sharing agreements between the insurer and affiliated entities which are abusive to the policyholders funds.

Slight Revision by AIA

Requiring a plan to be submitted by the group that allows all affiliated agreements and affiliated investments to be reviewed despite being below any materiality thresholds otherwise required by state law. A review of agreements between the insurer and affiliated entities may be particularly helpful to verify there are no cost-sharing agreements that are abusive to policyholders’ funds.

Rationale for Revision: The placement and use of “which” creates an ambiguity, suggesting that either “affiliated entities” or “cost-sharing agreements” are abusive to policyholders’ funds. Such a statement would be overly broad and factually incorrect. We believe the intent of the proposed language is that the analyst should conduct a review to identify abusive cost-sharing agreements -- where the focus would not be on all cost-sharing agreements, but only on those agreements that are abusive.