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The Potential Impact of Principles-Based Reserving on Acquisitions and Divestitures in the Life Insurance Industry

By Michael D. Devins and Michael K. McDonnell

As we describe in more detail in our article on page 3 of this issue of the Financial Institutions Report, the National Association of Insurance Commissioners (the "NAIC") is in the midst of a concerted effort to introduce a new, principles-based system of reserving for life insurance and annuity products in the United States. The proposed reform, while potentially significant for those active in life insurance industry transactions, remains subject to continuing deliberations among legislators and regulators. In all likelihood, the pace of reform will be slow, and the ultimate scope of the reform remains uncertain. Still, the adoption of principles-based reserving in the United States could have significant effects on future acquisitions and divestitures involving U.S. life insurers. In brief, statutory reserve assumptions and methodologies, company discretion in the calculation of reserves and the robustness of corporate governance and internal controls could become more important aspects of the due diligence investigations undertaken by buyers of life insurance businesses. Similarly, after the adoption of principles-based reserves, the allocation of risks associated with statutory reserve levels and calculations may play a more prominent role in the negotiation between buyers and sellers of contractual representations and warranties and other deal terms, including price.

The discussion that follows separates the potential effects of principles-based reserving on M&A practice into three basic categories: (1) potential changes in the process of due diligence and valuation; (2) the potential evolution of contractual representations, warranties and covenants in response to principles-based reserving; and (3) the potential effects of principles-based reserving on purchase price calculations and adjustments in acquisition agreements.

Due Diligence & Valuation

Regardless of the applicable regulatory regime, reserves are important to the valuation of any life insurance business, and will inevitably be a significant component of a life insurer's balance sheet. However, because of the relatively rigid, conservative nature of the current regulatory regime, and the corresponding lack of discretion exercised by management in the establishment of reserves, the level of an insurer's reserve liabilities has tended historically to be a less significant concern in a buyer's evaluation of a U.S. life insurance business. Instead, buyers have more often directed their focus to the strength of the asset portfolio that the life insurer has accumulated in order to support its reserve liabilities. In an attempt to match long-term life insurance policy liabilities with high-yielding assets, life insurers sometimes invest in illiquid assets with long durations. Buyers of life insurance businesses are understandably keen to understand the risks inherent in these types of assets, and in life insurance company investment portfolios generally, especially in light of recent turmoil in the investment markets.

While buyers will undoubtedly continue to focus on the asset side of life insurer balance sheets, the introduction of principles-based reserving may result in buyers paying increased attention to the calculation of reserve liabilities. This development could cause life insurance acquisitions to bear closer resemblance to deals involving property and casualty insurers where, under current rules, the determination of reserve adequacy can be highly subjective. Of course, the risks faced by life insurers will always

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Letter from the Editor

We focus this issue of the Debevoise & Plimpton Financial Institutions Report on a development that is of great importance to our many life insurance industry clients in the United States: the introduction of a system of principles-based reserving for life insurance and annuity products. This change will be the culmination of many years of work by state insurance regulators, and has been long anticipated by life insurance industry participants. Although effectiveness of the proposal awaits further drafting and review by the National Association of Insurance Commissioners (the "NAIC"), as well as enactment by state legislatures, it promises to have important implications for U.S. life insurers and for transactions in the life insurance industry. We explore a number of these implications in detail in this issue.

The efforts by state insurance regulators to introduce principles-based life insurance and annuity reserving is a component of a broader "solvency modernization initiative" undertaken by the NAIC in the wake of the financial crisis. The initiative is far-reaching in scope. Among other things, it includes a critical assessment by state insurance regulators of capital adequacy standards, corporate governance requirements, insurance holding company supervision and international regulatory coordination. In this issue, we address another regulatory effort that falls within its scope: the efforts by the International Association of Insurance Supervisors, in concert with the NAIC and insurance regulators in other jurisdictions, to introduce a framework to facilitate regulatory cooperation in the oversight of internationally active insurers.

Elsewhere in the world of financial institutions, the pace of regulatory activity continues to be intense. In the United States, we are monitoring the bevy of rulemaking efforts that are in progress among federal regulatory agencies in response to the recently enacted Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Similarly, we continue to follow a plethora of financial reform projects in other jurisdictions, including, among other things, work in the European Union to implement Solvency II.

We will continue follow and report on these developments in the Financial Institutions Report, in Client Updates and at client seminars. If there are topics of interest to you that you would like to see covered in future issues or in another forum, we would welcome your comments.

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An Overview of the NAIC's Principles-Based Reserving Initiative for Life Insurance and Annuity Products

by Michael D. Devins and Michael K. McDonnell

In September of 2009, the National Association of Insurance Commissioners (the "NAIC") adopted a revised version of its Model Standard Valuation Law (the "SVL") governing the calculation of reserves for life insurance and annuity products in the United States. If enacted into law by state legislatures, the revised SVL would implement the framework for a new principles-based approach to statutory life insurance and annuity reserves. This new approach would replace a legislative model for the regulation of reserves that has remained intact, in its basic form, since the mid-1800s. Under the existing regulatory regime, U.S. life insurers must calculate minimum required reserve levels using generally static formulas that are prescribed in state insurance laws. The required formulas apply in a uniform manner across the industry and give only limited discretion to company actuaries in the establishment of actuarial assumptions. The new system, in contrast, would be founded on flexible principles of risk analysis and stochastic modeling, and would permit a U.S. life insurer to establish its statutory reserves by reference, in part, to the insurer's unique, historical experience data. The new regime is likely to give company actuaries significant increased discretion to determine the actuarial assumptions that shape the calculation of minimum statutory reserves.

Although the scope of the likely reform remains uncertain, and is the subject of ongoing deliberations by the NAIC and state legislatures, the adoption of principles-based life insurance and annuity reserving is likely to have important ramifications for many aspects of the life insurance business in the U.S., including transactions that take place in the industry. On page 1 of this issue of the Financial Institutions Report, we discuss in detail some of the potential impacts of principles-based reserves on acquisitions and divestitures of U.S. life insurance businesses. To set the stage for that discussion, set forth below is a broad overview of the NAIC's principles-based reserving initiative.

The Determination of Life Insurance and Annuity Reserves under Current Law

In order to understand the new principles-based approach to reserves, it is helpful, at the outset, to describe the basic parameters that have historically applied to the calculation of minimum required statutory life insurance and annuity reserves. Minimum statutory reserve calculations require a comparison of the present value of expected premium revenues from a block of policies with the present value of expected benefit payments that will be made on those policies. This comparison is grounded on two core assumptions:

- an assumption regarding the rates at which the holders of a particular block of life insurance policies or annuities will die, often referred to for purposes of reserving calculations as the "mortality rate"; and
- an assumption regarding the rate at which the life insurer will accumulate investment earnings on the premiums that it receives from a particular block of life insurance policies or annuities before funds are needed to pay benefits, often referred to for purposes of reserving calculations as the "interest rate".

In the past, these two core assumptions have been determined largely by static regulatory prescriptions. Insurers have calculated applicable mortality rates by reference to mortality tables developed by state regulators and the NAIC. The applicable interest rate, in turn, has been a function of a detailed statutory formula linked to corporate bond yield averages published by Moody's Investors Service. In both cases, the prescribed assumptions have borne no specific relation to the actual mortality and investment experience of the insurer performing the calculation. Instead, these required assumptions, while informed by industry experience, have applied across the industry without variation. Regulators and industry representatives alike have increasingly criticized these required assumptions in recent years as blunt and inflexible.

The Historical Roots of the Current Regulatory Approach

The prescribed mortality tables that are in use today can trace their roots to the "Combined Experience Table of Mortality" first adopted by the Massachusetts legislature in 1858 on the basis of the experience of seventeen British life insurers from 1762 to 1833, and the "American Experience Table of Mortality" first adopted by the New York legislature in 1868 on the basis of the experience of a single New York life insurer. Although required mortality tables have since been replaced a number of times in order to account for advances in underwriting methods and life expectancies, and to incorporate a wider sample of industry experience, the basic legislative approach to mortality assumptions has remained the same over the years. The required mortality tables have been constructed, at the behest of regulators, on a

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conservative basis, with an eye toward ensuring solvency. Regulators have not typically allowed insurers to adjust the table to accommodate their own historical results or the individual judgment of their actuaries. In addition, applicable mortality tables have been updated relatively infrequently to account for new industry experience, on average about every twenty years. Once adopted, these periodic updates have not been given retroactive effect. For example, policies issued prior to the mid-1980s are typically subject to a mortality table based on experience data that is many years old. The minimum reserves that must be established for these policies therefore do not reflect improvements in life expectancy that have occurred since the development of the table. For example, reserves for many policies issued between the mid-1960s and the mid-1980s are based on a mortality table constructed in 1958 on the basis of the experience of 15 large insurers between 1950 and 1954, and reserves for policies issued prior to the mid-1960s are based on a mortality table that dates to 1941.

The required interest rate assumption has also historically been the result of a relatively inflexible regulatory prescription. For many life insurance policies issued prior to the early 1980s, the required interest rate assumption has simply been a rate specified by statute. For example, for many life insurance policies issued prior to the mid-1970s, the maximum permitted interest rate assumption is fixed by law at 3.5 percent. In the wake of record increases in market interest rates during the late 1970s and early 1980s, state insurance regulators introduced a more dynamic method for determining interest rate assumptions that derives the required rate, at the time of policy issuance, from an index of corporate bond yields. Despite this reform, the required interest rate has, in large part, remained linked to a prescriptive formula that takes no account of individual insurer investment experience. The required rate assumption also has not historically accounted fully for complex product features, such as minimum benefit guarantees, that may come under pressure when an insurer's investment performance proves to be more volatile than originally expected. It is also important to note that the required rate is fixed at the time of policy issuance, and is not adjusted periodically to account for the swings in investment performance that can affect an insurance company's asset portfolio over a number of years.

The Historical Treatment of Assumptions Beyond Mortality and Interest Rates

Of course, the determination of an actuarially sound reserve level is a complex exercise that is a function of far more than just mortality and interest rates. Policyholder behavior, for example, plays a critical role. The rate at which policyholders are expected to terminate coverage early voluntarily by surrendering their policies, or involuntarily by failing to pay required premiums (i.e., the "lapse rate"), is a critical component of any calculation of reserve adequacy. Assumptions regarding expenses, tax, inflation, reinsurance, hedging and other items are also important to the calculation. Historically, required minimum life insurance reserve calculations in the U.S. have not taken these other assumptions into account, at least not explicitly. Currently, for example, the SVL effectively requires, for purposes of the minimum reserve calculation, that an insurer assume that its life insurance policies will not lapse prior to the payment of benefits.

It would, however, be a gross mischaracterization to suggest that the regulation of life insurance company solvency and reserving has not historically accounted for factors beyond mortality and interest rate assumptions. At a minimum, the required mortality and interest rate assumptions, as a result of their inherent conservatism, implicitly address additional costs and risks associated with the conduct of a life insurance business. Moreover, the U.S. regulatory regime imposes a number of requirements that require a detailed evaluation of specific company experience and risk. For example, since the 1990s, insurance company actuaries have been required to render an annual actuarial opinion that includes, as an important component, a principles-based "asset adequacy analysis" designed to ensure that the company's assets are sufficient to fund its policy obligations. If the asset adequacy analysis reveals a deficiency in the formulaic statutory reserves, a company is required to strengthen its reserve levels (the analysis, however, cannot be relied upon to reduce minimum required reserve levels). Similarly, state insurance regulators require that insurers complete a detailed risk-based capital calculation using complex formulas that are intended to reflect accurately the full panoply of risks that a particular company faces in its business. If an insurer's risk-based capital level falls below minimum required levels, regulators are authorized, or in severe cases required, to take action to correct the problem. The adoption of asset adequacy and risk-based capital requirements over the past decades demonstrates a trend, in the regulation of insurance, toward the adoption of more sophisticated, finely calibrated means of evaluating and monitoring insurance company financial strength.

The Impetus for Regulatory Reform

Despite the regulatory advances described above, the basic calculations that determine minimum required life insurance and annuity reserves have remained firmly tied to prescriptive formulas that generally apply to

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the industry on a "one size fits all" basis, with only limited mechanisms to account for new and rapidly evolving product features, unique company experience and important assumptions beyond the applicable mortality and interest rates. The relative simplicity of this approach has its advantages. Among other things, a simple methodology is easily audited by regulators, and provides a clear basis on which to compare the reserve adequacy of different life insurers. In addition, the prescriptive nature of the approach puts the regulators firmly in control, mitigating the risk of abuse inherent in alternatives that might permit greater flexibility and discretion on the part of companies. Finally, the inherent conservatism of the traditional methodology arguably serves well the regulatory purpose of protecting policyholders.

In recent years, however, concern has steadily increased among both industry participants and regulators that the SVL's formulaic approach has become too inflexible. Industry participants, in particular, have argued that the SVL is often too conservative, giving inadequate credit to modern underwriting techniques, sophisticated investment models and more advanced risk management strategies. Regulators, in turn, worry that the SVL may not adequately capture the risks of increasingly complex products and industry practices, and is therefore no longer linked closely enough to the way in which modern life insurers conduct business. Among other things, regulators have shown concern that formulas give short shrift to "tail risk," or the risk associated with low probability events that may have a severe impact. Some regulators and interested parties also believe that the SVL, in its current form, presents opportunities for companies looking to "game the system" by exploiting loopholes in the required formulas. Both regulators and industry participants recognize that detailed, formulaic rules are difficult to adapt quickly, leading to a chronic lag between the introduction of new product features and the development of new regulatory reserve formulas designed to address those features. A comprehensive modernization effort, described below, is the result of this growing clamor for reform.

The shortcomings of previous modernization efforts have catalyzed a determined effort to seek a more radical reworking of the regulatory regime for reserves.

Regulations XXX and AXXX

In the recent past, the NAIC has implemented a number of reforms that have attempted to accommodate new products and practices in the life insurance industry while leaving the basic, formulaic structure of reserving regulation intact. For example, within the last ten years, the NAIC adopted new reserving regulations for level term insurance products (commonly known as "Regulation XXX") and for universal life insurance products with secondary guarantees (commonly known as "Regulation AXXX"). Regulations XXX and AXXX represented attempts to adapt the formulaic structure of reserving regulation to address more complex product features and new company risk management techniques. While these new regulations incorporated limited accommodations for individual company experience into the required reserving calculations, they did not fundamentally alter the prescriptive, formulaic approach reflected in the statutory scheme.

After adoption, Regulations XXX and AXXX quickly became the subject of heavy criticism. In particular, both regulations are widely understood to require reserves that exceed, by a substantial margin, the level of reserves needed to fund future policy obligations. In recent years, life insurers active in the relevant lines of business have entered into sometimes expensive and complicated reinsurance or financing transactions, increased prices or limited new business, all in order to address onerous reserve requirements under Regulations XXX and AXXX.

The Introduction of Principles-Based Reserves for Life Insurers

The shortcomings of previous modernization efforts have catalyzed a determined effort to seek a more radical reworking of the regulatory regime for reserves. In 2002, the NAIC began a comprehensive review of the SVL, with the assistance of the American Academy of Actuaries, in order to determine whether changes to the legislative approach would be advisable. This review continued over the course of several years, culminating in a decision to pursue a new system of principles-based reserving. The adoption of the new version of the SVL in September of 2009 represents the latest and perhaps most dramatic step in this chronology. The move toward principles-based reserving is also evident in the adoption of Actuarial Guideline 43 ("AG 43") effective December 31, 2009. AG 43 implements a principles-based approach to the valuation of minimum guaranteed benefits under variable annuity contracts. Parallel efforts are also under way to introduce principles-based approaches to the determination of life insurance company risk-based capital levels.

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Reduced to its essentials, the principles-based approach reflected in the new SVL and AG 43 shifts the primary responsibility for determining minimum required reserves, and the related assumptions and methodologies that support those reserves, from the regulators to the insurance companies that they regulate. Statutory and regulatory formulas are replaced, in large part, by a process that relies much more heavily on the judgment of company actuaries. This approach, it is hoped, will yield a reserving regime that can capture all of the material risks associated with a company's products and can adapt quickly to evolving industry practices. The principles-based approach is intended to bring the regulatory requirements into much closer alignment with company risk management techniques, and to produce statutory financial information that better reflects the underlying economics of the life insurance business.

The Regulatory Definition of a Principles-Based Approach to Reserves

In the current draft materials that would implement principles-based reserving, the NAIC describes a principles-based valuation as "a reserve valuation that uses one or more methods or one or more assumptions determined by the insurer . . . [T]his is in contrast to valuation approaches that use only prescribed assumptions and methods".[1] The text of the new SVL articulates a number of fundamental precepts for the principles-based system of reserving. According to the new SVL, a company applying a principles-based approach to its statutory reserve calculation must:

- "[q]uantify the benefits and guarantees, and the funding, associated with the contracts and their risks at a level of conservatism that reflects conditions that include unfavorable events that have a reasonable probability of occurring during the lifetime of the contracts";
- "[f]or policies or contracts with significant tail risk, [reflect] conditions appropriately adverse to quantify the tail risk";

The principles-based approach is intended to bring the regulatory requirements into much closer alignment with company risk management techniques.

- "[i]ncorporate assumptions, risk analysis methods and financial models and management techniques that are consistent with, but not necessarily identical to, those utilized within the company's overall risk assessment process, while recognizing potential differences in financial reporting structures and any prescribed assumptions or methods";
- incorporate assumptions that, unless specifically prescribed by regulation, are "established utilizing the company's available experience, to the extent it is relevant and statistically credible" or, to the extent there is no appropriate company data, "utilizing other relevant, statistically credible experience"; and
- "[p]rovide margins for uncertainty including adverse deviation and estimation error, such that the greater the uncertainty the larger the margin and resulting reserve".[2]

The Valuation Manual

The foregoing elements of the new SVL amount to general guidelines, and offer little in the way of specificity. This generality is purposeful. Much of the detail of the new reserving requirements will be set forth in a valuation manual that the NAIC continues to discuss and develop at the time of this writing. State insurance regulators envision the valuation manual as a reserving analogue to the NAIC's Accounting Practices and Procedures Manual, which codifies statutory accounting principles. Like the Accounting Practices and Procedures Manual, the valuation manual would be amended periodically by the NAIC in order to accommodate new regulatory policies or valuation changes needed to address new products or industry practices. The new SVL contemplates that states, where possible, would automatically adopt any NAIC amendments to the valuation manual without needing to pass new legislation or adopt new regulations.

The valuation manual will be divided into a collection of separate sections, each intended to address a particular product or a particular process that is needed to implement the principles-based approach contemplated by the new SVL. For example, state insurance regulators currently expect that AG 43 will be incorporated into the valuation manual once the manual comes into force. It is likely that different products will be phased in over time, with the development of principles-based reserves for some products coming later than others. At the time of this writing, the NAIC is focusing on the development of VM-20, which will set out principles-based reserving requirements for traditional individual life insurance products. The products addressed by VM-20 would include the types of products covered by Regulations XXX and AXXX.

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VM-20 has been the subject of vigorous debate within the NAIC, with some regulators, particularly New York, arguing for caution, and others arguing for a more aggressive approach. This debate is likely to result in the inclusion of a formulaic minimum within VM-20. In other words, VM-20 would require a minimum reserve that is the greater of (1) a prescribed formula that is similar in many ways to the reserve formulas that have been mandated historically, and (2) a more flexible, principles-based reserve that is determined by the insurance company through stochastic modeling of multiple scenarios. The details remain to be resolved. The impact of VM-20 will depend in large part on the strength of any formulaic component that is included in the calculation. A stronger formulaic component will mean life insurance reserving reform that entails less actuarial discretion and less flexibility.

The Role of Experience Data

Under the new SVL, the determination by a life insurer of principles-based reserves rests on actuarial assumptions derived from "relevant, statistically credible" data regarding the insurer's past experience. In order to facilitate regulatory oversight of actuarial assumptions, the new SVL contemplates a new reporting regime under which insurers will periodically file "mortality, morbidity, policyholder behavior, or expense experience and other data" with state insurance regulators or with statistical agents retained by the regulators.[3] Detailed reporting requirements will be set out in VM-50, a separate section of the valuation manual. The new SVL contemplates a robust set of statutory confidentiality protections for experience reporting data that is capable of being identified to particular companies or policyholders. It is contemplated, however, that the experience data would be pooled into a publicly available aggregate industry database. The database could be used both by regulators and other interested parties in order to test the actuarial assumptions used by particular companies in order to establish their reserves, and would also be available for use in the establishment of principles-based reserves by companies that lack their own credible experience data in a line of business.

Corporate Governance Requirements for Principles-Based Reserves

In the course of developing principles-based reserving reform, state insurance regulators have consistently expressed a desire to mandate strong corporate governance measures for the life insurance reserving process. The concern of regulators focuses specifically on minimizing the risk that companies will abuse the increased actuarial discretion that is inherent in a principles-based system. As a result, a separate section of the valuation manual, VM-G, will set out unique corporate governance requirements applicable to the establishment of principles-based reserves. The first paragraph of the current draft of VM-G articulates the regulatory concern succinctly: "[a] principles-based approach to the calculation of reserves places the responsibility for actuarial and financial assumptions with respect to the determination of sufficient reserves on individual companies, as compared with reserves determined strictly according to formulas prescribed by regulators. This responsibility requires that sufficient measures are established for oversight of the function related to principles-based reserves".

The new SVL therefore establishes a basic framework of corporate governance requirements applicable to the determination of principles-based reserves. Specifically, the new SVL requires that a company that is "using a principle-based valuation for one or more policies or contracts" must:

- "[e]stablish procedures for corporate governance and oversight of the actuarial valuation function consistent with requirements described in the valuation manual";
- provide to its board of directors and domestic state insurance regulator an annual certification of the effectiveness of its internal controls over principles-based reserves;
- ensure that its internal controls are "designed to assure that all material risks inherent in the liabilities and associated assets" subject to a principles-based valuation are included in the valuation, and that the valuation is made in accordance with the valuation manual; and
- "[d]evelop, and file with its [domestic state insurance regulator] upon request, a principle-based valuation report that complies with standards prescribed in the valuation manual".[4]

The current draft of the VM-G provides additional detail on these points and sets out a detailed hierarchy by which the determination of principles-based reserves should be supervised within a life insurance company.

According to the manual, just as directors are responsible in general for overseeing a corporation's affairs, they are also responsible for "general oversight" of the principles-based reserves actuarial function at a level that is "[c]ommensurate with the materiality of principles-based reserves in relationship to the overall risks borne by the insurance company".[5] The responsibilities of the board of directors will include oversight of:

- the process taken by senior management to correct material weaknesses in internal controls;

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- the adequacy of the infrastructure to implement and oversee principles-based reserves; and
- the documentation of "review and action undertaken by the board" relating to principles-based reserving in the minutes of the meetings of the board of directors.[6]

Similarly, the current draft of the valuation manual defines oversight responsibilities for senior management and company actuaries.

Specifically, senior management is charged with oversight of the actuarial function (including by ensuring that adequate infrastructure has been established, reviewing principles-based reserving elements and results, and addressing significant or unusual issues), adoption of internal controls, determining that resources are adequate, overseeing processes and review procedures, and communicating with the board of directors. In turn, one or more qualified actuaries must oversee the calculation of principles-based reserves, review assumptions, methods and models, provide a summary report to senior management and the board of directors, provide an opinion on the adequacy of reserves, and cooperate with internal and external auditors, regulators and senior management.

While the new SVL and valuation manual include significant detail regarding corporate governance, they are not intended to alter basic duties under applicable corporate law. In fact, the current draft of VM-G specifically notes that it does not expand "the existing legal duties of a company's board of directors, senior management and appointed actuary and/or other qualified actuaries".[7] Instead, the valuation manual indicates that it is intended "to emphasize and clarify how their duties apply to the principle-based reserves actuarial valuation function of an insurance company or group of insurance companies".[8] The valuation manual implies, for example, that directors may continue to rely on experts, where appropriate, in the oversight of principles-based reserving. Nonetheless, the adoption of principles-based reserves will require that directors and management devote significant attention to the establishment of procedures for compliance with the governance guidelines set forth in the new SVL and the valuation manual. The adoption of these detailed guidelines is likely to be important to regulators conducting examinations of company processes in the future (and, potentially, levying fines or imposing other penalties for non-compliance), and also to courts evaluating the prospect of liability for directors and officers in future legal actions.

Effective Date of Principles-Based Reserves; Prospective Application Only

Before it can take effect in any particular state, the new SVL must be enacted by the state legislature. In addition, the new SVL provides that the valuation manual will take effect on January 1 of the first calendar year following the first July 1 as of which all of the following have occurred: (1) the valuation manual is adopted by the NAIC by a vote of the greater of 75% and 42 of the NAIC's member insurance commissioners; (2) the new SVL, or substantially similar legislation, is enacted by states representing more than 75% of the direct life and health premium written in 2008; and (3) the new SVL, or substantially similar legislation, is enacted in at least 42 U.S. jurisdictions.

The NAIC has yet to adopt a final version of the valuation manual. Currently, the NAIC is pursuing an impact study, targeted for completion by March 31, 2011, to analyze the likely effect of principles-based reserving on the life insurance industry in the United States and to compare principles-based methodologies to those currently in effect. The ultimate timing for finalization and adoption of the valuation manual has been delayed several times already, and at the time of this writing remains uncertain. Once the manual is adopted by the NAIC, the new SVL will be submitted to state legislatures for enactment. It is likely that the process of legislative enactment will take several years.

The new reserving reforms embedded in the new SVL and the valuation manual, once effective, will apply prospectively to business written by life insurers after the effective date, but will not apply retroactively to reserves on existing blocks of business. Currently existing reserve requirements will continue to apply to policies that are already in force on the effective date. Although insurance companies will need to be ready to begin applying principles-based reserves to new products upon effectiveness of the reforms, principles-based reserving will have only a gradual effect on company financial profiles as new business is written and older blocks of policies run off. In light of political uncertainties and the inherently gradual process by which principles-based reserves will take effect, interested parties should expect any consequent changes in business and transactional practices to develop slowly. ■

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1. *See the September 2010 draft of the NAIC's principles-based valuation manual, available at http://www.naic.org/committees_lhatf.htm.*

2. *See NAIC Model Standard Valuation Law, § 12.A.*

3. *See NAIC Model Standard Valuation Law, § 13.*

4. *See NAIC Model Standard Valuation Law, § 12.B.*

5. *See the September 2009 draft of VM-G, available at http://www.naic.org/committees_ex_isftf_pbr_wg.htm.*

6. *Id.*

7. *Id.*

8. *Id.*

The Common Framework for the Supervision of Internationally Active Insurance Groups

by Michael K. McDonnell and Donald H. Guthrie

On July 1, 2010, the International Association of Insurance Supervisors (the "IAIS") began the development of a Common Framework for the Supervision of Internationally Active Insurance Groups ("ComFrame"). The IAIS is a multinational non-governmental organization that represents the principal insurance regulators of some 190 jurisdictions across the world. In a sense, the IAIS is the international analog to the National Association of Insurance Commissioners (the "NAIC"), which serves a similar role in the United States by facilitating coordination among state insurance regulators. Through ComFrame, the IAIS intends to provide a framework within which different countries will cooperate in the regulatory supervision of insurance companies that operate in multiple jurisdictions, referred to by the IAIS as "Internationally Active Insurance Groups" ("IAIGs").

Among other things, ComFrame is being developed in response to the recent financial crisis and is intended by the IAIS as a contribution to the work already being done in this area internationally. In the words of the IAIS, "a more integrated, multilateral framework for group-wide supervision is needed . . . for supervisors to address regulatory gaps in a harmonised manner as opposed to individually and in isolation". Ultimately, ComFrame may come to serve an important role in coordinating the work of insurance regulators engaged in the supervision of insurers across international borders. Depending on the course of its development, ComFrame could have important impacts on insurers operating internationally and on international transactions in the insurance industry. For this reason, the development of ComFrame will likely be worthy of close attention by industry participants. Set forth below is an overview of ComFrame as well as a brief summary of activities undertaken by U.S. state insurance regulators in response to the ComFrame initiative.

An Overview of ComFrame

The IAIS has articulated three primary goals for ComFrame, as follows:

- develop methods of operating group-wide supervision of IAIGs in order to make group-wide supervision more effective;
- establish a comprehensive framework for supervisors to address group-wide activities and risks and also set grounds for better supervisory cooperation in order to allow for a more integrated and international approach; and
- foster global convergence of regulatory and supervisory measures and approaches.

Among the other things, the IAIS has noted that it intends that ComFrame will provide a "modus operandi" for the supervision of IAIGs and, accordingly, will focus on (1) "the business structure, business mix and business development of the [IAIG] from the perspective of risk management", (2) "quantitative and qualitative requirements" and (3) "supervisory cooperation and interaction".

ComFrame will be headed by an IAIS task force, and will be developed through the work of existing and, where needed, new working groups within the IAIS. The IAIS plans to organize the work of developing ComFrame into "modules" – in other words, areas of similar subject matter that relate to the overarching goals of the ComFrame project. Currently, five "modules" comprise ComFrame, as follows:

- scope of application;
- group structure and business;
- quantitative and qualitative requirements;
- supervisory cooperation and interaction; and
- jurisdictional matters.

In terms of timing, ComFrame is still in its initial stages of development. A concept paper providing an in-depth overview of the framework is targeted for completion by mid-2011. In total, the IAIS expects that the development of ComFrame will take three years. The IAIS has emphasized its expectation that the framework will be the subject of continuing refinement to reflect changing circumstances and experience gained over time. The IAIS has also noted its intention to consult regularly with industry representatives and experts as the project progresses.

The Response of U.S. State Insurance Regulators

As a member of the IAIS, the NAIC is seeking to contribute to the development of ComFrame. To that end, the NAIC has been heavily engaged in review and discussion of the proposal. In July of this year, the NAIC sponsored a symposium on the supervision of IAIGs. Subsequently, through a series of conference calls and in-person sessions at its periodic national meetings, the NAIC has begun to formulate its initial response. In recent discussions, the NAIC's Solvency

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Modernization Initiative (EX) Task Force (the "SMI Task Force") has identified a handful of points that may merit discussion within the IAIS. Most recently, at the NAIC's 2010 Fall National Meeting this month, members of the SMI Task Force endorsed a proposal, to be presented by NAIC staff at the IAIS annual conference from October 27 to 29 in Dubai, for the establishment of a standing IAIS committee of lead regulators of internationally active insurers. The proposed committee would meet regularly, in closed session, to share and discuss information and trends relating to relevant internationally active insurers. Several members of the SMI Task Force have expressed the view that this proposal would be a fruitful area of initial focus for the ComFrame project.

Implications for the Insurance Industry

The effects of ComFrame on the insurance industry will depend on the nature of the project's development. At this stage, it is not entirely clear how comprehensive the project will become or whether it will ultimately prove successful. A variety of outcomes is possible. On the one hand, ComFrame may ultimately serve primarily as a means of facilitating the sharing of information among insurance regulators in different jurisdictions. On the other hand, one could envision a much more active role for ComFrame in the promotion of international regulatory convergence. In either event, it is clear that significant work is on the horizon. Among other things, regulators will need to analyze legal constraints that can sometimes pose a challenge to international regulatory coordination, including, for example, confidentiality restrictions that may limit information sharing across borders. ■

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differ fundamentally from those faced by property and casualty insurers. The prediction, on an actuarial basis, of insured losses from natural disasters, for example, is inherently more uncertain than the prediction of mortality rates on the basis of large and diverse historical samples. Still, the valuation of life insurance reserve liabilities is certainly not free of subjective, volatile components, particularly in the case of assumptions regarding investment earnings and policyholder behavior. Undoubtedly, the discretion offered to management in the establishment of principles-based life insurance reserves introduces the possibility of increased subjectivity and volatility in reserve levels. This possibility may be especially pronounced in the context of a change in control, since the buyer's views of appropriate actuarial assumptions and methodologies could differ materially from the seller's historical approach. Buyers of life insurance businesses may need to guard more carefully against the risk that a material strengthening of statutory reserve levels may be needed after the closing of an acquisition.

As part of a due diligence evaluation of a life insurance business, buyers will have a number of options available in order to probe more deeply into the calculations and processes that surround a life insurer's determination of reserve levels. Sellers of insurance businesses commonly retain an independent actuarial firm to carry out a reserve study and prepare a valuation report for review by potential buyers. This important component of the buyer's due diligence may take on added prominence after the introduction of principles-based reserving. Buyers will likely want to focus specifically on vetting the credibility of the historical data used by a target life insurance business to establish its reserves. In addition to reviewing this data, and related company assumptions and calculation methodologies, buyers may also look to compare company experience data to the data collected and analyzed by insurance regulators under the terms of the regulatory valuation manual that will govern principles-based reserving determinations (for a more detailed description of the valuation manual, see page 6 of this issue of the Financial Institutions Report). Depending on the final terms of the valuation manual, it is possible that a buyer of a life insurance business will be able to vet a target company's relevant experience data against a publicly available database of aggregate industry experience data that is contemplated by the draft regulations currently under consideration by the NAIC. Finally, potential buyers may start relying more on their own modeling of a target's business (as many already do), building their own actuarial analyses from the ground up at the policy level rather than simply accepting the seller's actuarial appraisal at face value.

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Other reserve-related items may also draw greater scrutiny in connection with due diligence. In light of prominent new corporate governance guidelines embedded in the NAIC model legislation that will implement principles-based reserving, buyers of life insurance businesses will likely be interested in undertaking a close review of the oversight procedures and internal controls established by a company to govern the determination of reserves (for an overview of relevant provisions in the NAIC model legislation, see page 7 of this issue of the Financial Institutions Report). Similarly, buyers may bring a new focus to the review of regulatory communications relating to an insurer's reserve calculations, processes and governance procedures. It is likely, as a result, that company actuaries will take on added prominence in the due diligence process, and sellers will be well advised to involve knowledgeable actuaries early in the process of a buyer's due diligence review.

Although the effects of principles-based reserving may be significant for due diligence and valuation of U.S. life insurance businesses, it is important not to overstate these potential effects, especially given the obvious uncertainty surrounding the NAIC's ongoing deliberations regarding the specific terms of principles-based reserving regulations. Even if a system of principles-based reserves ultimately comes into force in one of its more radical potential iterations, the process of valuing a life insurance company is unlikely to shift to a paradigm that is completely divorced from current practice. Among other things, principles-based reserving reforms are designed to apply prospectively only to new business written after effectiveness of the reforms. Policies that are already in force at such time will continue to be subject to existing reserving regulations. In addition, the process of determining reserves for non-regulatory purposes is likely to remain substantially unchanged in its basic contours. For example, the introduction of principles-based statutory reserving will not radically affect the calculation of reserves under U.S. GAAP, which have long eschewed the prescriptive, formulaic approaches that have historically dominated statutory reserve valuations. Still, the development of principles-based reserving will have important implications for the determination of price in an acquisition, as regulatory measures inevitably play a key role in the valuation of life insurance businesses, and such businesses are not uncommonly valued on a statutory, rather than GAAP, accounting basis for the purpose of determining price. Indeed, regulatory requirements determine, ultimately, how much capital must remain within a life insurance company over time to support its liabilities, and therefore are directly relevant to the amount of earnings that a buyer can reasonably expect to realize from a life insurance business.

Representations, Warranties and Covenants

Ultimately, an increased focus on vetting reserve levels is likely to manifest itself in the negotiation of specific deal terms. For example, historically, acquisition agreements for U.S. life insurance businesses have commonly included a seller representation and warranty to the effect that the life insurer has calculated its reserves in a manner that is consistent, or materially consistent, with an agreed set of actuarial and accounting standards (for example, "generally accepted actuarial principles," "sound actuarial principles," "statutory accounting principles," etc.). In transactions involving a non-public target company, this representation is typically linked, along with other seller representations, to the seller's obligation to indemnify the buyer for losses resulting from breach of such representations (subject, as is customary, to thresholds, caps and other negotiated limitations). Currently, because legally required reserve assumptions and methodologies are relatively rigid, a representation of this kind gives a buyer a great deal of comfort that reserves have been established at an appropriate level. The introduction of principles-based reserving may cause buyers to seek more robust representations and warranties that address not only calculation methodologies, but also the sufficiency of the reserve levels that have resulted from the insurer's calculations, since it would be harder for a buyer to demonstrate a breach of an actuarial methodologies representation where the required methodology leaves so much to the target company's discretion. When coupled with an indemnity for breach of representation, representations of this kind, depending on the drafting, could amount to a guarantee of the ultimate adequacy and sufficiency of reserve levels, which in the current market would be considered an aggressive request for a buyer to make. As an alternative to a representation regarding the sufficiency of reserves, buyers might borrow a technique sometimes used in property and casualty deals by suggesting a special, stand-alone indemnity or a reinsurance cover to protect against the risk of insufficient reserves. In either case, these types of buyer requests are likely to prove controversial. The difficulty of negotiating these types of contractual protections may put additional pressure on buyers to pursue a more in-depth due diligence review of actuarial methods and calculations.

The introduction of principles-based reserving may also prompt changes to other deal terms outside of the reserves representation. It is not unusual, for example, to see buyers request a representation regarding the sufficiency of an insurer's internal controls. Because principles-based reserving may substantially increase the

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flexibility and discretion involved in the calculation of reserves, and will introduce new regulatory requirements relating to internal controls, this representation would be likely to attract greater scrutiny. For example, buyers may ask to add specific elements to this representation in order to address the adequacy of controls used in the establishment of reserves, as well as the compliance of those controls with the detailed corporate governance guidelines that are set forth in the NAIC's model reserving legislation. Again, in transactions involving a non-public target company, sellers should expect that this type of representation will be linked to an indemnification provision. Depending on the terms, and the limitations that may apply to the indemnity, this type of representation could operate to shift economic responsibility back to the seller for procedural and regulatory failings in the calculation of reserves prior to the closing of a divestiture.

A similar dynamic may inform a number of other representations that often appear in acquisition agreements for life insurance businesses. Acquisition agreements commonly include representations covering matters such as: (1) compliance by the target business with applicable insurance laws and regulations; (2) the completeness and accuracy of insurance regulatory filings; (3) the existence and materiality of insurance regulatory investigations and other actions; (4) the conformity of individual policy terms and conditions to a company's reserving assumptions and methodologies; (5) reserve credit for reinsurance; and (6) the accuracy and completeness of a company's books and records. The implementation of principles-based reserving is likely to change the conduct of U.S. life insurance businesses in ways that affect all of these representations. These types of representations are typically drafted in relatively general terms in order to ensure broad applicability, so that the introduction of principles-based reserving may not evidence itself in any noticeable changes to the customary wording that is used to make these representations in acquisition agreements. At a minimum, however, practitioners will need to be cognizant of the effects of principles-based reserving in order to ensure the completeness of disclosure schedules that are customarily delivered by sellers in order to qualify the representations. For example, matters that may merit disclosure in the future include regulatory inquiries into the processes used by a company to establish its reserves, weaknesses identified in a company's internal controls over the principles-based valuation process, and specific uncertainties identified by a company's actuaries in the determination of appropriate reserve levels, among others.

In addition to seller representations regarding the target business, acquisition agreements also typically include a set of interim operating covenants that bind the conduct of the target life insurance business during the period between the signing of the agreement and the closing of the transaction. Because required state insurance regulatory approvals often take a significant amount of time to obtain, this period may extend over several months in a U.S. life insurance industry acquisition. The interim operating covenant is designed, for the benefit of the buyer, to restrict the operation of the target business while regulatory approvals are pending and the business remains under the ownership and control of the seller. The buyer's interest, essentially, is to ensure that the target business is preserved during this period. This covenant will often include a restriction that prohibits or restricts changes to the policies and practices used by the seller to determine the target's reserve levels between signing and closing. The introduction of principles-based reserves will increase the scope of a company's discretion to effect period-to-period changes in its reserving practices, likely bringing added scrutiny by buyers of the reserve-related components of the interim operating covenant. At the same time, a principles-based system may make it more difficult for sellers to agree to terms that restrict actuarial discretion. Indeed, the principles-based system will require that company actuaries exercise prudent discretion on an ongoing basis, adapting assumptions and methodologies flexibly in order to accommodate changes in experience. Company actuaries understandably may be reluctant to endorse contractual restrictions that might prevent a company from adapting to changed circumstances. Moreover, onerous prohibitions against reserving changes could, in fact, violate regulatory requirements in the new NAIC model legislation that effectively mandate an exercise of actuarial discretion, likely creating an impossible situation for a seller that will obviously need to continue complying with law between signing and closing. As a result, the negotiation of restrictions on reserve changes in the interim operating covenant may very well become more challenging. In particular, despite a new impetus to lock down reserving assumptions and calculation methodologies after signing, buyers may be forced to accept terms that, by necessity, give sellers some flexibility to adapt their reserving practices while the closing is pending. Buyers, however, can seek financial protection against this risk through a purchase price adjustment mechanism that captures pre-closing changes in reserve levels, as we describe in more detail below.

Contractual Purchase Price Calculations and Adjustments

The price agreed between a buyer and a seller at the time of signing of the acquisition

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agreement is typically based on the valuation of the target life insurance business as of that time. Of course, this valuation may change during the period between the signing of the acquisition agreement, when the buyer is legally committed to purchase the business, and the closing, when ownership actually changes hands. Changes in valuation may occur as a result of factors that are outside the control of the parties to the transaction. Changes in macroeconomic conditions, or the actions of third parties like rating agencies or regulators, may cause the value of the business to fluctuate before the closing occurs. Factors within the control of the parties, and in particular the seller, can also materially affect the value of the business between signing and closing. Changes to reserving assumptions and methodologies are an excellent example of this type of factor.

Because a significant amount of time may pass between the signing and closing of a deal in the life insurance industry, the allocation between the buyer and seller of pre-closing changes in valuation is frequently a key issue in negotiations. Acquisition agreements in the life insurance industry frequently include a mechanism to adjust the price agreed at signing on the basis of changes in the target's financial position up to the closing date. This type of mechanism helps to ensure that the seller will retain the economic risks and benefits of the business before the change in control is consummated at closing.

In life insurance transactions, purchase price adjustment mechanisms are often linked to the book value of the insurer. In many instances, U.S. insurance companies regularly prepare financial statements only on a statutory basis, rather than a U.S. GAAP basis. As a result, the contractual book value calculation is often linked, by necessity, to regulatory measures of valuation, such as capital and surplus. As a consequence, statutory reserve levels often play an important role in determining the purchase price agreed at signing and any adjustment to the purchase price that may be due after closing.

The introduction of principles-based reserving has the potential to change the negotiation of purchase price adjustments in significant ways. Because principles-based reserving may bring a noticeable degree of new flexibility and discretion for management in the calculation of statutory reserves, the challenge of drafting precise reserve-related criteria to govern the determination of the purchase price will become more acute. After the introduction of principles-based reserving, for example, buyers and sellers might be expected to prepare and attach to acquisition agreements a detailed set of schedules setting forth agreed reserve calculation assumptions and methodologies. While this often occurs currently, these types of schedules would likely become more detailed to accommodate principles-based reserving. One might expect to see purchase price schedules that specify parameters to govern the scope of permissible actuarial assumptions with a great deal of specificity, necessitated by the greater number of permissible outcomes under principles-based reserving.

Procuring a specific and precisely drafted set of contractual terms to govern the purchase price, and related purchase-price adjustments, is likely to be particularly desirable because these terms are both crucially important to the deal and often rather complex. A principles-based system will introduce more complexity, which in turn makes it more difficult for counsel to ensure that the drafting accurately reflects the business understanding regarding valuation and price. If the parties to a transaction do not reach a clear, detailed agreement on the components of the purchase price and the mechanics of its calculation, a heightened risk of dispute is inevitable. Deal counsel can add significant value by minimizing the risk of this type of dispute with clear and focused drafting that is informed by a fundamental understanding of the valuation process. Close cooperation between lawyers and actuaries is critical to ensure that a complete and accurate set of methodologies is included in the agreement.

Conclusion

While state insurance regulators have made significant progress in the development of a principles-based system for life insurance reserving, several years are still likely to pass before the new system takes effect. In addition, the ongoing regulatory debate regarding the scope of the project means that the precise nature and extent of the principles-based reform remains unclear, and may remain unclear for some time. Even after adoption, principles-based reserving will have no retroactive effect, and will only gradually begin to assume importance in statutory valuations of life insurers as companies begin to write new business under the new system. Nonetheless, the adoption of principles-based reserving represents a fundamental shift in regulatory approach. Even if regulators introduce principles-based reserving reform in a cautious, measured manner, as appears to be the case, the regulatory change, over time, may have a profound effect on the life insurance business in the U.S., and consequently on M&A practice in the life insurance industry. Certainly, for those active in the world of life insurance industry deals, the progress of principles-based reserving bears watching. ■

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