Debevoise & Plimpton

Insurance Industry Corporate Governance Newsletter

To Our Clients and Friends,

The November edition of our Insurance Industry Corporate Governance Newsletter focused on social inflation, the impact it has on the industry, how to address it and how the effects of social inflation factor into corporate governance.

This month, as we prepare to turn the calendar from 2022 to 2023, we review some of the key transactional and regulatory themes that we have observed during the past year and expect to carry forward into 2023.

Short-Term Disruption in the Transactional Environment

Broadly speaking, 2022 was a tale of two years in the insurance transactional world. The early portion saw transactions driven by the macroeconomic reverberations from the prior two years, while the latter portion was defined by the uncertain, and at times bearish, outlook. Heading into 2023, we believe that the factors that drove recent transactional activity should continue, and corporate decision-makers should consider whether and in what ways their longer-term strategies are affected by the current disruption.

As many of our clients know first-hand, over the past several years the insurance industry has experienced a significant uptick in corporate transactions. The rapid pace of activity during that period was driven by a number of factors, including the protracted low interest rate environment, investor pressure to generate shareholder returns by simplifying business lines and freeing capital, the growing role of shareholder activism and the increasing role of private equity in the insurance industry. The confluence of these and other factors contributed to the high volume of M&A, disposition transactions, spin-offs and partial IPOs in 2020 and 2021. These themes carried into early 2022, and significant activity was driven by deals that were struck in 2021 but did not close until 2022 due to the time required to obtain regulatory approvals.

After a summer slowdown to the frenetic pace of deal-making, we observed a marked shift in the drivers of corporate transactions as we moved toward the end of 2022. The changing macroeconomic climate, including dislocation in the equity markets, rising interest rates and the consequential higher cost of capital, contributed to a slowdown in acquisitions and paved the path for a number of proposed and completed preferred equity issuances, reinsurance and sidecar transactions and other complex financing structures as issuers seek the lowest cost of capital available in the market and providers of capital (including, in many cases, private equity) continue to sit on significant amounts of dry powder.

As we look to 2023 and beyond, there may still be a temporary mismatch in valuation of assets between acquirers and sellers, especially for public companies. However, over the longer term, the continued disaggregation of the life insurance sector, coupled with the keen interest of private equity in, particularly, the fee-earning portions of the insurance industry, should reignite transactional activity. Furthermore, over time insurance companies will benefit from the rising interest rate environment, though companies should consider how best to bear the short-term costs as portfolios mature.

Continued Evolution of the Regulatory Environment

From a regulatory perspective, 2022 saw a continued focus, in particular, on the use by insurers of emerging technology and the impact of the changing macroeconomic environment in the insurance industry.

Artificial intelligence ("AI") has evolved rapidly in recent years and is transforming the way companies make decisions, underwrite policies, handle claims, market and advertise, and strategically invest in emerging products. As companies increasingly depend on AI for everything from back-office operations to core business lines, insurance regulators have kept a sharp eye on the use of these models. 2022 saw a continued evolution in the patchwork regulatory response to AI and other emerging technology in areas from proxy discrimination to new cybersecurity rules focused on governance, technology and risk assessments. We expect to see continued focus from regulators on this area in 2023, and with that focus we may also expect the risk of private litigation to emerge.

During 2022, the National Association of Insurance Commissioners focused on a wide range of topics in response to the changing macroeconomic environment and the attendant evolution of the insurance industry. In particular, the NAIC has concentrated on such matters as:

- the increasing role of private equity,
- CLO risk charges (and concerns regarding "RBC arbitrage" with respect to structured assets more generally) and, recently,
- the impact and treatment of negative IMR driven by the increased interest rate environment.

In addition, the NAIC has adopted, and the SEC has proposed, heightened disclosure requirements in respect of climate change.

The SEC also continues to evaluate and promulgate rules that will impact insurance groups in important ways, including the new universal proxy card rules and potential rules that would impact the valuation of Rule 144A securities, and proposed rules enhancing the disclosure around share repurchases.

From a corporate governance perspective, companies must continue to focus on compliance with this multifaceted regulatory regime, disclosure requirements and emerging litigation risk.

Conclusion

Following the whirlwind deal-making in recent years, 2022 was a reminder that the insurance industry remains dynamic and rapidly evolving no matter the economic climate, presenting both new risks and opportunities on which to remain focused.

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