Debevoise & Plimpton

Insurance Industry Corporate Governance Newsletter

To Our Clients and Friends,

The April edition of our Insurance Industry Corporate Governance Newsletter focused on how the insurance industry and insurance regulators are concentrating on unfair discrimination (including proxy discrimination) in insurance underwriting and rating.

This month, we look at corporate separations and how they are being used to alter the landscape in the life insurance and annuity industry. These separations have wide-ranging implications for the industry and have proven to be a critical aspect of delivering shareholder value.

Business Separations in the Life Insurance and Annuity Industry

The roots of corporate separations can be traced back to the development of retirement and protection products with design features intended to compete in an increasingly competitive market for consumer financial assets. These products have proven in many cases to require heavier amounts of capital than anticipated, due to factors such as changing product regulation, the protracted low interest rate environment, changing morbidity and mortality assumptions, evolving accounting standards and, in some cases, acquisitions of companies by non-U.S. owners subject to Solvency II and IFRS regimes that are not well suited to these products.

The question on the table for companies that own these businesses is: should we still own them, at least in their current configuration, or is there possibly a better structural home for them?

The tool kit for addressing this question includes some or all of the following elements:

- Runoff and Product Design. A first step in managing a capital-heavy block may be to stop selling the product, or to redesign it in such a way as to mitigate the capital strain. This is often easier said than done, as regulatory constraints and the practical need to continue to make competitive products available for a distribution force to sell to consumers can limit corporate flexibility.
- Financing. Some products, for example level premium term life insurance and universal life with secondary guarantees, have proven susceptible to financing solutions. These financing structures are often dependent on the formation of a captive insurer and reinsuring the capital-heavy product features to that captive. While effective, these structures require intensive regulatory review, can be costly to establish, and in some cases depend on the availability of third-party financing sources, and so are unreliable as a complete solution.
- Dispositions. Products that have been put in runoff, including in some cases those that have financing structures already in place, can be good candidates for sale, and in particular for a transfer from public company to private capital ownership. In the life and annuity industry, dispositions of this nature can be structured as either reinsurance or a sale of a legal entity. The reinsurance structure raises issues of counterparty credit and thus can be more difficult to explain to investors and analysts than a legal entity sale. In our experience, though, so many large reinsurance dispositions have been completed at this point that investors and analysts most likely understand the nature of recapture risk, which can be heavily negotiated in the deal documents.

- Sidecars. Many companies are looking at ways to lighten the load of capital requirements by establishing sidecar entities, often in non-U.S. jurisdictions, funded with third-party capital, sometimes in a partnership with a private equity firm. These vehicles can be used to assume business either on a runoff or future flow basis, and benefit the ceding company by transferring the business to an entity formed in a jurisdiction without the same capital-intensive requirements and where the assuming company is an affiliate of the ceding company, thus removing some of the counterparty risk inherent in other reinsurance dispositions. The transfer alleviates capital strain on the ceding company, allowing the ceding company to continue to write new business and redeploy capital into other areas. For more detail on the increasing prominence of sidecars in the life and annuity sector, join our webinar here.
- Spin-offs and Partial IPOs. Some companies have gone a step farther and isolated capital-heavy business into a SpinCo entity that can then be carved out and distributed to existing shareholders or into a vehicle that can be sold to investors in an IPO, typically with subsequent secondary sales. For example, MetLife, Inc. and Prudential plc used spin-offs in recent years to exit the U.S. life and annuity sector, AXA S.A. sold its U.S. life business in an IPO and more recently, AIG, Inc. filed for an IPO of its life and retirement business. While a spin-off or IPO has the benefit of allowing for a relatively clean exit from a capital-heavy business, such transactions are not without execution risk. Regulatory approvals will almost certainly be required in connection with internal restructurings to transfer business (including entities, personnel and contracts) to a SpinCo or IPO vehicle, to disentangle and prop up standalone operations and to dispose of a controlling interest in an insurer or, where applicable, approve a new control person. Insurance regulators may require additional capital contributions be made to the insurance companies once those companies no longer have the implicit support of the distributing or selling parent, making a spin-off or IPO potentially expensive. Further, a spin-off or IPO can be a lengthy process and, in the case of an IPO, ultimate timing may be subject to market conditions outside of a company's control.

While the deal structures described above are quite divergent in terms of the amount of risk transfer, counterparty risk, regulatory issues, execution risk and other key factors, they all share a focus on balancing the need to write competitive products and grow business organically with the imperative to manage capital efficiently and ensure companies have the resources needed to make investments in technology, people and other forward-looking aspects of their business.

What Companies Should Do Now

The issue of efficient capital management is common to every company operating in the insurance sector. The better that companies can strike a balance between organic growth and efficient management of capital, the more likely they are to be able to decrease their cost of capital and continue to compete effectively without undergoing major structural change.

With that in mind, we are hopeful that the framework described above can be a useful tool for boards and the senior management of life insurance and annuity companies as they think about the options for managing capital-intensive businesses.

Conclusion

At the core of corporate governance for life insurance and annuity companies lie many questions about the most efficient allocation of capital resources—*e.g.*, how to build a company that looks to the future but also appropriately manages its legacy liabilities.

The business separation structures described in this newsletter are intended to help companies develop a framework for thinking about these issues and to understand the tools available as they undertake that critical exercise.

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