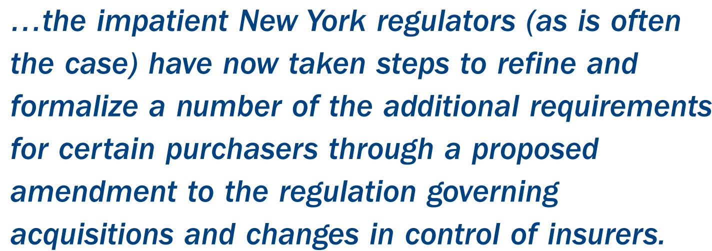
 By Peter H. Bickford

Regulatory Paranoia

It started over a year ago, in a speech before a prestigious conference on the state of the U.S. and world economies, when New York's Superintendent of Financial Services first raised the warning signs against private equity firms "becoming active in the acquisition of insurance companies" because "these private equity firms are more short-term focused – when [insurance] is a business that's all about the long haul." Since issuing this warning shot, the issue of hedge funds and private equity firms investing in the insurance business has become a topic of significant discussion and some action. The New York regulators, for instance, imposed increased capital requirements and scrutiny on the 2013 acquisitions by private equity firms of two insurance company issuers of fixed and variable annuity products. These additional requirements, all consented to by the purchasers, included the establishment of a trust for the benefit of policyholders. As a basis for these additional requirements, the NY regulators used a statutory catchall provision allowing the Superintendent to require submission of "such information as he deems necessary . . . as a condition of approval" of an acquisition or change in control of an insurer.

Following suit (as is often the case) the National Association of Insurance Commissioners (NAIC) established a working group late last year to study whether acquisitions of insurers by private equity and similar firms required heightened scrutiny. Rather than wait for or participate in the conversation at the NAIC or National level, the impatient New York regulators (as is often the case) have now taken steps to refine and formalize a number of the additional requirements for certain purchasers through a proposed amendment to the regulation governing acquisitions and changes in control of insurers.



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Many of the additions to the proposed regulation (which may be final by the time you read this column) are to reflect the changing world of investment over the years. For instance, the amended regulation adds general partners and managing members of limited partnerships, limited liability companies or similar entities – entities that did not exist when the existing law and regulations were first conceived - to the list of entities or individuals that are required to disclosure detailed information. The amended regulation also specifically requires disclosure of materials used to solicit investors, including any offering memoranda or disclosure statements.

Existing requirements are also expanded. For instance, the existing discretionary requirement for a detailed plan of operations is now a specific requirement including five-year financial projections. Also, the required disclosure of future plans to liquidate, sell or merge the insurer is expanded to include future plans to declare dividends or change the insurer's investment portfolio, and no changes can be made in these plans without approval of the regulators. It is here where the amended regulation starts to deviate from establishing criteria for the acquisition of an insurer to a questionable "off-the-books" regulatory supervision of future conduct.

For instance, the new regulation requires the filing of new five-year projections if at any time within five years of acquisition the company enters into a reinsurance agreement, investment arrangement or asset transaction with a controlled or controlling entity. While these might be appropriate signals for regulatory review or control, as presented here they seem to be expanding regulatory control over certain purchasers of insurance companies through the initial approval process inconsistent with or outside the statutory regulatory framework. Not only does this undermine the finality of a purchase with the threat of future revocation, it also raises the question of exceeding statutory authority.

One of the more interesting examples of the reach of the new regulation is the imposition of a trust requirement on purchasers of life insurers. Any purchaser of a controlling interest in a life insurer must establish a trust account "in an amount and for a duration to be determined" by the superintendent if "absent such action, the acquisition is likely to be hazardous or prejudicial to the insurer's policyholders or shareholders." Although limited to life insurers at this time, the "Regulatory Impact Statement" published in the State Register makes it clear that "[t]he Superintendent always had, and retains, the discretion to condition an acquisition, in appropriate circumstances as needed, on the fulfillment of additional requirements, including the use of a trust or other financial backstop where a non-life insurer is being acquired." In other words, the regulators can ask for anything they want whether specified in the regulation or not.

It is likely that the NY regulators in their insecurity and paranoia may simply be seeking to codify the requirements imposed on the two acquisitions of annuity issuers by private equity firms in 2013. The effect of the regulation, however, is much broader and could have significant long-term impact on the ability of New York insurers to obtain needed capital in

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the future. Also, the fact that two entities, intent on closing a deal, were willing to accept the imposition of future controls over their ownership, should not be considered as "precedent" to justify regulatory rather than legislative codification of these controls.

Particularly troubling is the trust requirement: an expansion of the purpose of such trusts into an area where they simply were not intended to fit. Historically trust agreements were used to secure credit for reinsurance cessions to alien reinsurers by ensuring access to assets within the US, or as a basis for approval or "white listing" of alien surplus lines carriers by – again – ensuring access in the US to assets in the event claims are not timely paid. Using trusts as supplemental capitalization tools for the establishment or operations of domestic companies in their home state was not contemplated – until now!

The trust requirement in the new regulation begs the question: if the regulator deems that an acquisition "is likely to be hazardous or prejudicial to the insurer's policyholders or shareholders" without a trust agreement, why approve the acquisition at all? Or why not simply insist on a greater capital base? Our insurance laws are constructed and designed for the proper conduct of the business of insurance regardless of ownership. Why then must the rules for the future conduct of business be dependent on the nature of ownership?

By imposing these new regulatory controls on the acquisition of insurers, not only is the DFS perpetuating its insecurity and paranoia over certain legitimate capital sources, but it is also establishing a dangerous precedent for future regulatory supervision of the day-to-day operations of insurers.[IA]

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