

I. Apollo-Aviva Insurance Deal and Private Equity Firms' Involvement in the Insurance Industry: Mismatches in Risk Appetites and Appropriate Policyholder Protections

A. Introduction

In December 2012, Athene Holdings, Ltd., an affiliate of private equity firm Apollo Global Management, announced its \$1.55 billion acquisition of Aviva USA, a distressed annuities business.¹ The deal prompted public and regulatory concern over the risks posed to annuities policyholders,² particularly when private equity firms manage the insurance company's assets.³ Private equity funds eagerly make higher-risk investments and generally employ a greater amount of leverage than traditional insurance company owners.⁴ The mismatch between private equity investment strategies, which seek high-yield returns after intermediate exit timelines of three to five years, and the priorities of annuities purchasers, motivates this regulatory concern.⁵

¹ Karen Freifeld, *Apollo Agrees to Policyholder Protections in Athene-Aviva Deal*, REUTERS (Aug. 14, 2013, 5:18 PM), <http://www.reuters.com/article/2013/08/14/us-apollo-aviva-nydeal-idUSBRE97D16D20130814>.

² Joe Gardyasz, *A Game-Changing Deal for Athene*, BUSINESS RECORD (Aug. 8, 2013, 1:00 PM), <http://www.businessrecord.com/Content/Finance--Insurance/Finance---Insurance/Article/A-game-changing-deal-for-Athene/171/833/59513>.

³ Zachary R. Mider, *Apollo-to-Goldman Embracing Insurers Spurs State Concerns*, BLOOMBERG (Apr. 22, 2013, 12:00 AM), <http://www.bloomberg.com/news/2013-04-22/apollo-to-goldman-embracing-insurers-spurs-state-concerns.html>.

⁴ Benjamin M. Lawsky, Superintendent, N.Y. State Dep't of Fin. Servs., Remarks at the 22d Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies in New York City (Apr. 18, 2013) [hereinafter Lawsky Speech], available at http://www.dfs.ny.gov/about/speeches_testimony/sp130418.htm (“[Private equity firms] may not be long term players in the insurance industry and their short-term focus may result in an incentive to increase investment risk and leverage in order to boost short-term returns.”).

⁵ *Id.*; *Application of Apollo Global Management LLC, Leon Black, Joshua Harris, and Marc Rowan for the approval of a plan to acquire control of Aviva Life and Annuity Company, Aviva of Iowa, Inc., Aviva Re Iowa II, Inc, and Aviva Re Iowa III, Inc. Before the Ins. Comm'r of the State of Iowa 2* (2013) (written testimony of Jim Baker, Research Coordinator, UNITE HERE), http://www.pecloserlook.org/wp-content/uploads/JBaker_

Policyholders are more concerned about the long term, with the expectation that the insurance company will be in a position to pay out its promised benefits.⁶ Insurers make explicit “promises to pay” their policyholders.⁷ However, those “promise[s] to pay [are] valuable only so long as the insurer making the promise is financially capable of performing when the insured loss actually occurs.”⁸ According to New York Superintendent of Financial Services Benjamin M. Lawsky, the typical private equity investment strategy does not neatly fit with traditional insurance company risks, where insolvency can shift a large risk burden onto policyholders.⁹

Notwithstanding regulatory concern, Iowa and New York insurance regulators approved the Apollo-Aviva transaction in August 2013, subject to certain policyholder protections.¹⁰ These protections include more stringent capital reserve requirements and stricter disclosure requirements.¹¹ In response to the growing trend of private equity firms’ buying annuities businesses,¹² the National Association of Insurance Commissioners (“NAIC”) has formed a working group, the Financial Analysis Working Group (“FAWG”), to develop policy recommendations for dealing with private equity firms’ newfound appetite for entering the insurance industry.¹³

Testimony_Iowa_re_Athene_7-17-2013_Final.pdf [hereinafter Baker Testimony].

⁶ Lawsky Speech, *supra* note 4.

⁷ KENNETH S. ABRAHAM, INSURANCE LAW AND REGULATION, 122 (5th ed. 2010).

⁸ *Id.*

⁹ Lawsky Speech, *supra* note 4.

¹⁰ Elizabeth Festa, *Iowa OKs Athene Buy of Aviva*, LIFEHEALTHPRO (Aug. 16, 2013), <http://www.lifehealthpro.com/2013/08/16/iowa-oks-athene-buy-of-aviva> (discussing Iowa’s approval and restrictions); Freifeld, *supra* note 1 (discussing New York’s approval and restrictions).

¹¹ Festa, *supra* note 10.

¹² DELOITTE DEV. LLC, TOP 10 ISSUES FOR INSURANCE M&A IN 2013: TIME FOR MERGERS AND ACQUISITIONS TO TAKE OFF?, 7 (2013), http://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/MA/us_ma_top10%20issues%20for%20insurance%20MA_03112013.pdf.

¹³ Client Memorandum, Leah Campbell & Allison J. Tam, Willkie, Farr & Gallagher LLP, NAIC to Consider Private Equity Investments in Life & Annuity Insurers 1 (May 20, 2013), http://www.willkie.com/files/tbl_s29Publications%5CFileUpload5686%5C4387%5CNAIC_To_Consider_Private_Equity_Investments.pdf.

This article outlines the annuity business acquisition market, analyzes current recommended policyholder protections, and discusses future implications of heightened protections. Part B will discuss the continuing development of private equity firms' entering the insurance business. Next, Part C will provide an overview of the current insurance regulatory structure. Part D will then analyze NAIC's reform recommendations and annuitant concerns. Finally, Part E will discuss potential future developments in the insurance company acquisition market.

B. Why Private Equity Firms are Buying Insurance Companies

Private equity firms are acquiring insurance companies in their investment strategies with increasing frequency.¹⁴ Deloitte Development LLC has identified three reasons for this phenomenon:

First, many [private equity] firms are sitting on ready cash and looking for investment options in a low-return marketplace in which good deals can be difficult to find. . . . Second, many life insurance companies are trying to sell-off their volatile variable annuity business. . . . Third, [private equity] firms like to invest in niche insurance markets, such as reinsurance and fee-based businesses that provide services to insurance companies and the reinsurance market because they can offer a quicker return on investment (ROI).¹⁵

However, some commentators are concerned that the new private equity acquirers will attempt to generate high dividends from the assets of their purchased insurance businesses.¹⁶ Private equity firms are likely to employ "aggressive" investment management strategies

¹⁴ DELOITTE DEV. LLC, *supra* note 12.

¹⁵ *Id.*

¹⁶ *See, e.g.*, Darla Mercado, *Private-Equity Jumping into Annuities Could be Bad News for Insurers*, INVESTMENTNEWS (Jan. 29, 2013, 3:04 PM), <http://www.investmentnews.com/article/20130129/FREE/130129941>; Baker Testimony, *supra* note 5.

by relying on portfolio managers to invest in riskier assets in their quest to generate higher returns.¹⁷

Between 2010 and 2012, private equity firms acquired more than 100 insurance company targets.¹⁸ In addition to Apollo's recent takeover of Aviva, Guggenheim Partners acquired Sun Life Financial, Inc.'s annuities business.¹⁹ In August 2012, Guggenheim affiliates announced their purchase of Industrial Alliance Insurance and Financial Services, Inc.'s annuities division.²⁰ However, state regulators have not granted approval for all of the recent acquisitions.²¹ For instance, Harbinger Group, which invested in risky high-yield junk bonds, attempted to buy an annuity business, Old Mutual PLC, in 2011.²² Later, however, Maryland state insurance regulators rejected the deal, stating that the proposed acquisition could negatively impact policyholders, because Harbinger had not assured the Maryland insurance commissioner that it would be able to adequately protect against the risk of insolvency.²³ Although such acquisitions face roadblocks from regulators, several commentators expect the recent trend in private equity acquisitions to continue throughout 2013.²⁴

C. State Regulation of Insurance and Heightened Policyholder Protections

Currently, regulation of the insurance industry is reserved to the states.²⁵ Generally, state insurance regulators are concerned with

¹⁷ Mercado, *supra* note 16.

¹⁸ DELOITTE DEV. LLC, *supra* note 12.

¹⁹ Maria Wood, *Guggenheim Affiliate Buys Sun Life Annuity Business for \$1.35B*, LIFEHEALTHPRO (Dec. 17, 2012), <http://www.lifehealthpro.com/2012/12/17/guggenheim-affiliate-buys-sun-life-annuity-busines> (announcing that Delaware Life Holdings, a Guggenheim subsidiary, agreed to the purchase of Sun Life's annuities division for \$1.35 billion).

²⁰ *Id.*

²¹ *See, e.g.*, Mider, *supra* note 3.

²² *Id.*

²³ *Id.*

²⁴ DELOITTE DEV. LLC, *supra* note 12.

²⁵ 15 U.S.C. § 1011 (2012) ("Congress hereby declares that the continued regulation and taxation by the several States of the business of insurance is in the public interest, and that silence on the part of the Congress shall not be construed to impose any barrier to the regulation or taxation of such business by the several States.").

promoting insurance company solvency.²⁶ Attempting to further this end, states employ a variety of tools to minimize the risk that an insurance company will be unable to pay its policyholders.²⁷ These include “minimum capitalization, surplus, and reserve requirements; [mandated] disclosure of various kinds of financial information; . . . [and] control [over] the kinds and proportions of investments insurers can make.”²⁸

New York regulators have conditionally approved each of the Guggenheim and Apollo deals.²⁹ Guggenheim agreed to (1) increased risk-based capital requirements; (2) prior approval from the New York Department of Financial Services (“NYDFS”) for “[a]ny material changes to Guggenheim’s plan of operations of Sun Life New York, including investments, dividends or reinsurance transactions”; and (3) quarterly, as opposed to annual, financial reporting to the NYDFS.³⁰ In addition, Guggenheim agreed to set up a “backstop trust account . . . to provide policyholders with protection beyond the heightened capital levels.”³¹ Apollo has agreed to a very similar set of conditions, although Apollo and the NYDFS have agreed to a lower funding level for the backstop trust account.³²

²⁶ SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 90–91 (1959) (“The prevention of insolvency and the maintenance of ‘sound’ financial condition in terms of fixed-dollar obligations is precisely what traditional state regulation is aimed at.”).

²⁷ Robert H. Jerry II, *Insurance*, in OXFORD COMPANION TO AMERICAN LAW 420, 422 (Kermit L. Hall ed., 2002).

²⁸ *Id.*

²⁹ Freifeld, *supra* note 1.

³⁰ *Legal Alert: Acquisitions of Insurers by Private Equity Firms Under Heightened Regulatory Scrutiny*, SUTHERLAND (Sept. 18, 2013), <http://www.sutherland.com/NewsCommentary/Legal-Alerts/156719/Legal-Alert-Acquisitions-of-Insurers-by-Private-Equity-Firms-Under-Heightened-Regulatory-Scrutiny> [hereinafter *Legal Alert*].

³¹ *Id.*

³² *Id.* (stating that Apollo agreed to a \$35 million backstop trust account, less than the \$200 million requirement of the Guggenheim acquisition of Sun Life).

D. NAIC's Proposed Best Practices and Consumer Concerns

The NAIC is continuing to weigh in on the recent private equity acquisitions of insurance companies.³³ Specifically, FAWG has provided a set of “best practices” for state regulators to follow when such regulators impose heightened policyholder protections on insurance company acquirers.³⁴ FAWG recommends that regulators (1) use financial analysts to determine the appropriateness of the acquirer’s investment strategy; (2) stress-test the acquired insurance companies for required capital ratios; (3) require firms to agree to capital requirements; (4) require heightened financial disclosures; and (5) force private equity firms to disclose information “regarding investment returns necessary to meet investor demands.”³⁵ Additionally, FAWG has recommended that state regulators continually analyze the insurance company’s financials, including the financial health of its affiliates, and cooperate with overseas regulators.³⁶

Nonetheless, some consumer advocates are still concerned that the new insurance company owners have not done enough to ensure appropriate risk-reduction to protect against insolvency.³⁷ For example, during testimony in Iowa regarding the insurance commissioner’s approval of Apollo’s acquisition of Aviva, one researcher expressed concern that Athene’s capital reserves may not be adequate to cover future annuity contracts.³⁸ He also wanted assurance (1) that Athene’s portfolio of risky assets would be appropriate for Aviva’s policyholders; (2) that an investment strategy that employs high illiquidity risks is well-suited to the purposes of supervising and investing in assets over the long term; and (3) that

³³ Campbell & Tam, *supra* note 13.

³⁴ *Id.*

³⁵ *Id.* at 2.

³⁶ *Id.*

³⁷ *See, e.g.*, Baker Testimony, *supra* note 5, at 8.

³⁸ *Id.* (“What is the appropriate level of capital needed to support the annuity contracts going forward? Is Athene’s stated target of 7–10% capital to reserve ratio and 10x to 14x leverage ratio appropriate? Is the \$100 million in capital support so far pledged by Apollo Global Management to support the Aviva acquisition sufficient?”).

Apollo would be able to “behave as long-term stewards of the retirement savings of tens of thousands of annuitants.”³⁹

E. Future Developments in the Insurance Company Acquisition Market

Given that Apollo and Guggenheim accepted heightened regulatory scrutiny,⁴⁰ the market for insurance company acquisitions by private equity firms will likely continue.⁴¹ However, the New York and Iowa conditions may have unintended effects. Regulators justify heightened regulatory scrutiny by depicting potential insurance company purchasers as “private equity firms.”⁴² In the future, the market might expect potential acquirers to seek to characterize their investment strategies as atypical and less leveraged than the typical private equity firm to avoid regulators’ conditions, such as those set by the NYDFS and the Iowa Insurance Division.⁴³ Moreover, neither of the two state regulators has provided public guidelines as to which types of non-private equity acquirers would be exempt from the heightened annuitant protections.⁴⁴ Finally, traditional insurers may attempt to distinguish themselves from private equity funds to convince prospective sellers of annuities businesses that their takeovers will not result in regulatory approval delays.⁴⁵

Notwithstanding the regulators’ good intentions, the new protections might pose cost-management problems for insurance companies.⁴⁶ Unless all of the other various state regulators adopt similar (if not identical) requirements, insurance companies “would have to engage in repetitive, time-consuming, and costly filings and compliance activities; at worst, they would be whipsawed by

³⁹ *Id.*

⁴⁰ Festa, *supra* note 10 (discussing Apollo’s acceptance of Iowa’s regulatory restrictions); *Legal Alert, supra* note 30 (discussing Guggenheim’s acceptance of New York’s regulatory restrictions).

⁴¹ DELOITTE DEV. LLC, *supra* note 12.

⁴² *Legal Alert, supra* note 30.

⁴³ *Id.*

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ See RICHARD SCOTT CARNELL, JONATHAN R. MACEY, & GEOFFREY P. MILLER, *THE LAW OF FINANCIAL INSTITUTIONS* 569 (5th ed. 2013) (“The McCarran-Ferguson Act’s allocation of insurance regulation to the states presents obvious problems of regulatory complexity and overlap.”).

conflicting rules.”⁴⁷ The prospect of spending many more millions of dollars on compliance activities across inconsistent state regulation may result in undesirable consequences for policyholders.⁴⁸ Because insurance companies are likely to pass these additional compliance costs onto the policyholder, regulators must provide consistent guidelines if they wish to make the new requirements beneficial to current and future policyholders.⁴⁹

F. Conclusion

Commentators currently disagree as to whether these new acquisitions of insurance businesses will have a net positive effect for policyholders.⁵⁰ On one hand, savvy private equity owners are acquiring insurance companies because the market believes private equity firms employ better managers that can maximize wealth for the entire industry, benefiting policyholders who are invested in more successful, financially stable insurance companies.⁵¹ On the other hand, private equity firms’ risk appetite may be fundamentally at odds with the preferences of the more risk-averse traditional insurer.⁵² As long as private equity firms and other alternative investment managers continue to enter the insurance company acquisition market, states must cooperate to ensure that policyholders retain adequate protections against insolvency.⁵³ Only through cooperation will state insurance commissioners be able to avoid

⁴⁷ *Id.*

⁴⁸ *Id.*

⁴⁹ Elizabeth F. Brown, *Will the Federal Insurance Office Improve Insurance Regulation?*, 81 U. CIN. L. REV. 551, 566 (2012).

⁵⁰ Compare DELOITTE DEV. LLC, *supra* note 12 (“The industry is in the early innings of a general rebound: volume, pricing power, and economic activity are moving in the right direction . . .”), with Baker Testimony, *supra* note 5, at 1 (“Because of this inability to quickly liquidate a contract, annuity owners are like sitting ducks when a company undergoes a merger or other significant transformation. The only line of defense policyholders have against radical changes in the risk profile of the assets underlying their annuities is state insurance commissioners who must approve transactions such as the one that is the subject of today’s hearing.”).

⁵¹ Note, *Developing A Demutualization Acquisition Strategy for Private Equity Firms*, 110 HARV. L. REV. 1904, 1921 (1997).

⁵² Baker Testimony, *supra* note 5, at 9.

⁵³ See, e.g., SEC v. Variable Annuity Life Ins. Co. of America, 359 U.S. 65, 90–91 (1959).

imposing costly, inconsistent, or inefficient regulation on the insurance industry as a whole.⁵⁴

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⁵⁴ See CARNELL, MACEY, & MILLER, *supra* note 46.

⁵⁵ Student, Boston University School of Law (J.D. 2015).