

The 2009 Insurance  
M&A Outlook  
Opportunity in an  
uncertain environment



Dear Colleague:

Although insurance M&A acquisition activity declined sharply in 2008 and the first quarter of 2009, we believe activity is likely to increase later this year. Large financial institutions and insurers are likely to seek ways to divest their non-core insurance businesses in order to fund potential capital shortfalls. This trend could spark a new wave of acquisitions as more insurance companies are likely to be available at attractive valuations. As 2009 unfolds, we could also see deep-pocketed sovereign wealth funds based in the Middle East and Asia step up their interest in insurance acquisitions.

As described in this paper, strategic buyers seeking to expand their markets and geographical reach in today's insurance M&A arena appear to be focusing on growth, distribution and scale. They may be keeping a close eye on large financial institutions seeking to divest their insurance operations. They are likely reevaluating their own investment portfolios. And they are expected to carefully scrutinize the investment portfolios of their potential M&A targets.

In the following pages, members of Deloitte's national insurance M&A steering committee provide an in-depth analysis of 10 key factors they expect to have the most impact on insurance M&A acquisition activity in 2009. Near-term considerations include capital challenges and low valuations. Regulatory and financial reporting considerations include the potential for national regulation as well as the drive for International Financial Reporting Standards. Such standards, if adopted, could provide global M&A players with more consistent financial information and valuations.

We hope you find this report informative and helpful as you look ahead to M&A in 2009.

Sincerely,



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# Introduction

After several strong years of insurance M&A activity, closed deals and valuations were down sharply in 2008. The financial crisis and significant catastrophe-related losses in the third quarter of last year – combined with lower investment returns, ratings downgrades and a global economic recession – have created a “perfect storm” within the insurance M&A arena. As a result, insurance M&A buy-side activity approached an all-time low as 2008 drew to a close. The only bright spot in insurance M&A was the relative weakness of the U.S. dollar during most of the 2007-2008 period, which made U.S. insurers potentially attractive acquisition targets for foreign buyers seeking to increase their presence in the U.S. insurance market.

The subprime crisis and widespread credit losses, which have had a wrenching impact on commercial and investment banks around the world, are now having a significant impact on the insurance industry. There is growing activity in potential sell-side insurance M&A as a number of large banks and other types of financial institutions seek to divest non-core insurance operations as part of broad-scale efforts to fund capital shortfalls stemming from subprime write-offs and credit losses. In addition, some major insurance companies – hurt by sizeable subprime losses, mortgage defaults and equity losses – are seeking to raise capital by selling all or parts of their operations. At the same time, however, buy-side insurance M&A activity is weak, reflecting a scarcity of potential buyers. Many potential strategic buyers on the buy-side are likely preoccupied with their own problems. What’s more, many private equity firms that had been major players in insurance M&A in the past are now on the sidelines.

## Weak currency fueled interest

On a global basis, the weak U.S. dollar during most of the 2007-2008 period made U.S. insurance companies particularly attractive targets for foreign insurers seeking to leverage the strengths of the Euro and other high-value currencies. Although a wave of foreign buyers was active in the U.S. market from 1999 to 2001, many of these foreign buyers subsequently sold their U.S. operations. In recent years, however, foreign buyers have once again been focusing on the U.S. insurance market. During the 2007-2008 period, four out of six of the largest U.S. insurance M&A transactions were the result of foreign companies entering the U.S. market through acquisition. Likewise, foreign insurers have recently been making significant equity investments in major U.S. insurance companies. However, the U.S. dollar has recently strengthened and this may have an impact on the future direction and level of cross-border insurance M&A activity.

New players are also entering the insurance M&A marketplace. Sovereign wealth funds (SWFs), in particular, have been emerging as key players in global capital markets. Based largely out of the Middle East and Asia, SWFs are funded primarily by oil and merchandise exports and boasted some \$3 trillion in assets, according to the Deloitte report, *Insurance Firms: The Missing Link in the Sovereign Wealth Fund Acquisition Spree*, dated June 2008. Acquisitions have enabled SWFs to jump-start the development of their home-country financial markets. Up to this point, these acquisitions have not included insurance firms, which play an integral role in the development of financial markets and economies overall. However, it is likely that SWFs will seek to invest in insurance firms in the near future as Middle Eastern and Asian governments strive to increase the sophistication of their financial sectors by gaining access to needed resources and skills.

## Strategic buyers driving market

Within the insurance M&A arena, buying momentum is increasingly shifting from private equity firms to strategic buyers whose core business is insurance. Typically, such buyers often seek to achieve synergies in growth, distribution and expenses. They may want to enter new markets and lines of business in order to expand their customer and revenue bases and geographical reach. To a growing extent, such buyers appear to be pursuing smaller, targeted deals in an attempt to fill out product lines, enhance distribution channels, or address gaps in core competencies.

The opportunity to achieve greater economies of scale is another strong motivator for strategic buyers. Larger players that have made major investments in scalable business platforms and technology may be looking to acquire books of business in order to leverage these investments. In addition, many insurers may want to leverage the high costs of compliance, including expenses associated with the transition to International Financial Reporting Standards (IFRS).

## Capital challenges emerge

A number of capital-related factors also point to an increase in insurance M&A buy-side activity. During 2006 and 2007, market conditions encouraged organic growth, so property and casualty (P&C) companies faced relatively little pressure to pursue growth through acquisitions. During the same period, most P&C insurers and reinsurers benefited from relatively low levels of global catastrophes and enjoyed strong balance sheets and capital positions as a result. As they entered 2008, many companies were looking for ways to deploy excess capital.

Typically, insurers can deploy excess capital in one of three ways: first, by writing more business; second, by returning capital to shareholders by increasing dividends or by using excess cash flows to buy back stock; and third, by making an acquisition. As we entered 2009, the primary challenges for some life and P&C companies had shifted from finding ways to deploy excess capital to raising new capital. P&C companies have been hit by subprime, equity and catastrophe losses while life companies have experienced declines in fair value of investments and significant volatility in financial markets causing guarantees on variable annuities to project future losses. Thus, many life and P&C firms are experiencing significant losses of capital as well as downturns to their ratings. As a result, companies in both the life and P&C industries are searching for ways to raise capital, divest non-performing or capital-consuming businesses, or seek protection from better capitalized firms.

Another challenge suggesting an increase in insurance M&A buy-side activity is that, with the exception of D&O lines, most of the insurance industry is still in a soft pricing market. This factor makes it more difficult for insurers to achieve organic premium growth and makes potential growth through acquisition look more attractive. Although some analysts are projecting a hardening of insurance premium rates beginning in late 2009, this may be difficult to achieve as the global economic slowdown continues and creates some downward pressure on rates. However, such pricing pressures are unlikely to have the same impact on all insurers, given that many consumers are already seeking the safety of better capitalized insurers.

#### **The M&A outlook in 2009**

Consolidation within the insurance marketplace is likely to pick up once companies have, hopefully, put their financial problems behind them. For both life and P&C companies, mergers and divestitures can serve as a potentially effective means to increase capital and maintain ratings. Moreover, it appears many large financial institutions and insurers are looking to shed non-core insurance businesses in order to raise capital. This could fuel a new wave of acquisitions as more insurance companies may be available at attractive valuations.

The big question: Who will buy? On a global basis, acquisition-minded insurers are likely paying close attention to developing and emerging markets because of their potential for profitability. However, with global equity markets dropping nearly 40 percent in value toward the end of 2008, corporate stock has lost its allure as an acquisition currency. What's more, many insurers may not have sufficient cash to fund acquisition activity. In such

an uncertain M&A environment, the most likely acquirers, other than Chinese or Japanese companies flush with foreign currency, may well be those Bermuda and European insurers that have avoided major investment losses.

For buyers, an overriding challenge will be to structure deals without increasing exposure to investment portfolio losses. To this end, some strategic buyers are seeking to acquire underwriting teams instead of companies, a less risky, and less expensive, way of acquiring desired competencies. In addition, many financial services firms may be looking to acquire a life or annuity company in an effort to gain a bigger slice of the burgeoning retirement market.

#### **When insurance M&A buy-side activity picks up steam**

Historically, insurance M&A buy-side activity tends to be quite cyclical, driven largely by catastrophes, the premium cycle, regulatory developments and investment returns. Here are five situations where M&A activity is likely to increase:

**Following a catastrophe** – Weakened balance sheets can force companies to divest operations or pursue deals simply to survive. Recent examples of this phenomenon include the impact of 9/11 on P&C businesses in the U.S. and the U.K and the impact of the 2005 hurricane season on U.S. insurers.

**At the beginning of a hard pricing market** – Opportunistic insurers and private equity capital will often seek to capitalize on hard-market profit opportunities. In 2003 and again in the 2005-2006 period, capital entered the insurance industry to take advantage of hard-market pricing opportunities in the P&C industry. Many Bermuda reinsurers were also formed during this timeframe.

**At the beginning of a weak pricing market** – At such times, insurers begin to view M&A as a viable alternative to organic growth and private equity investors seek to cash out of their investments.

**As the result of regulatory developments** – In recent years, regulatory developments and investigations have had an impact on insurance M&A activity. During 2004 and 2005, uncertainty surrounding bid-rigging and reinsurance investigations contributed to a weak M&A cycle in the P&C sector.

**When investment returns are low** – M&A activity often picks up when investment returns are low and insurers are seeking alternative investments for their capital. At such times, insurers will frequently use acquisitions of companies or books of business as a means to deploy excess capital in a strategic manner.

# 10 key factors affecting insurance M&A

With the approach of the new year, members of Deloitte's national insurance M&A steering committee weighed in on what they consider to be 10 key factors likely to affect insurance M&A considerations in 2009. The committee divided these factors into two groups, as follows:

## Near-term impact:

1. Evolving M&A strategic objectives
2. Investment valuations & subprime exposures
3. Capital challenges
4. Low valuations
5. Integration challenges

## Regulatory & financial reporting considerations:

6. Changes in insurance company regulation
7. Push for IFRS
8. Principles-based reserves
9. Fair value reserving
10. Tax issues & legislation

## 1: Evolving M&A strategic objectives

To develop effective M&A strategies, focus on growth, distribution and scale. Explore new ways to access, manage and redeploy capital. Consider targeting insurance operations of larger financial institutions, many of which are looking to divest. Find ways to tap into the growing retirement market. Scrutinize the investment portfolios of potential M&A targets. And consider taking a four-phased, structured approach to the M&A process that focuses on strategic planning, target screening, transaction execution and integration.

With organic growth now more difficult to achieve, insurance companies need to be responsive to emerging M&A opportunities yet avoid moving too quickly. To achieve this balancing act, consider a structured, strategic approach to mergers and acquisitions as opposed to dealing with opportunities on an ad hoc basis. Consider defining a clear end-state vision for the company and develop a strategic M&A acquisition plan for achieving that vision. Understand a proposed deal's long-term strategic implications and alignment with your organization's long-term corporate strategy. And "stress test" the economics of the deal against both positive and negative economic scenarios.

Here is a starter list of key considerations for crafting effective M&A strategies:

- Focus on growth, distribution and scale
- Consider targeting insurance operations of larger financial institutions, many of which are looking to divest
- Alternatively, consider "purchasing" underwriting teams, rather than legal entities, to mitigate risk
- Plan for increased deal competition from strategic buyers and new entrants
- Consider alternative structures to protect against the downside risk of further asset devaluations
- Scrutinize the investment portfolios of potential M&A targets
- Find ways to tap into the growing retirement market, potentially your greatest area of opportunity

## Addressing distribution & capital management: key priorities

To reach a broader range of potential customers, consider expanding and leveraging distribution capabilities. Knowing how time-consuming it is to enhance a distribution network internally, acquisitions may provide a faster and more cost-effective means to expand distribution networks effectively. It's basically a "build vs. buy" decision.

To increase chances of being successful in today's insurance environment, companies will likely also need better ways to access, manage and redeploy capital. Think about acquiring companies or books of business to deploy excess capital strategically. And, be on the lookout for new capital management tools.



For more strategic considerations, see the Strategic Objectives Checklist below.

#### **Strategic Objectives Checklist for Insurance M&A**

- Pursue synergies in growth, distribution and expenses
- Achieve greater economies of scale
- Enter new markets and lines of business
- Expand geographical reach
- Expand and leverage distribution network
- Leverage technology & compliance costs
- Pursue targeted deals to expand product lines, enhance distribution channels, or address competency gaps
- Acquire blocks of existing in-force policies
- Acquire underwriting teams
- Tap into retirement market
- Divest non-performing or capital-consuming businesses to focus on core operations
- Divest non-core insurance operations to address capital shortfall
- Deploy excess capital

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#### **A four-phased, strategic approach to Insurance M&A**

Mergers and acquisitions within the insurance industry involve a host of decisions surrounding target selection and due diligence as well as transaction execution and integration. Given the diverse nature of these activities, M&A decision-making processes need to be balanced and inclusive and allow for a broad range of perspectives. Decisions should reflect input from marketing and sales, operations, production, research and development, and IT as well as from heads of business units and finance and accounting managers. Decision makers should also tap into key external sources, as appropriate, and include input from people with practical, day-to-day business knowledge. Failure to add such a practical dimension is a common weakness of low M&A achievers.

To plan and execute mergers and acquisitions effectively, insurance companies should consider a structured approach to the M&A process that focuses on four distinct phases: M&A strategy, Target screening, Transaction execution, and Integration.

##### **Phase I: M&A strategy**

Business strategies should drive development of M&A objectives. Too often, however, insurance companies pursue M&A targets simply because they are available and managements think they can do deals at favorable prices. Such thinking, known within the M&A industry as “deal fever,” can easily lead to questionable acquisitions and poor strategic fits. Effective dealmakers plan strategically and link their M&A strategies to five-year business plans. And they develop comprehensive M&A plans that enable the new combined entity to achieve a smooth “day one” transition by providing for systematic communications and addressing any change management issues.

##### **Phase II: Target screening**

Target screening is a highly structured process designed to narrow a broad range of possible acquisition candidates down to a manageable group of prospective targets. Experienced M&A organizations find that factoring their unique people, cultural, process, and technology considerations into the target screening phase can significantly improve their valuations and overall M&A efforts.

##### **Phase III: Transaction execution**

Effective due diligence is critical to merger success and is the primary activity in the transaction execution phase. When performed properly, due diligence can provide a foundation for structuring and valuing an M&A transaction, developing financing strategies, and targeting operational improvement efforts once a deal is complete.

Due diligence teams, in addition to examining key financial factors, should consider the need to look at operational and administrative issues as well as IT, compliance, human resources and tax considerations. They need to pay close attention to accounting practices, tax matters, actuarial methodologies, legal barriers and regulatory histories in addition to potential issues surrounding the integration of existing IT platforms. And they need to be on the lookout for potential deal breakers that could impact the valuation of a target company. In the current market, an evolving trend is the due diligence of risk management policies and procedures.

##### **Phase IV: M&A integration**

The challenges associated with M&A integration are driven by the need for organizations to complete multiple tasks simultaneously. Such tasks – which include integrating systems, processes and people as well as building a new IT platform – have to be completed in a compressed timeframe and under regulatory scrutiny while continuing to run a business and without negatively affecting customers, employees or suppliers. To increase the likelihood of a successful integration, first develop a clear, comprehensive integration plan to facilitate sustainable action targeted to results. Then have members of the integration team take part on the due diligence and execution teams so they can gain firsthand knowledge of issues and opportunities.

## 2: Investment valuations and subprime exposures

Turbulent credit markets and volatile equity markets are making it increasingly difficult to value the investment portfolios of insurance companies, raising the importance of portfolio due diligence. On the subprime front, some financial institutions are seeking to raise external capital while others are seeking to divest non-core insurance operations in order to free up capital to offset subprime losses. As the financial markets continue to show stress levels, additional asset classes, like commercial mortgage-backed securities, which experienced unprecedented spread pricing levels in late 2008, may require continued focus in 2009.

Turbulent credit markets and volatile equity markets are making it increasingly difficult to value the investment portfolios of insurance companies, as witnessed by the negative impact of adverse credit market conditions and limited liquidity on bond portfolios and the private placement market. As a result, it is important for potential buyers to place increased emphasis on investment portfolio due diligence to help mitigate post-closing investment losses. With regard to asset-backed securities, for example, potential acquirers need to understand how a target assesses cash flow projections and the basis for its assumptions. And when dealing with mortgage-backed securities, in particular, potential acquirers need to understand how a target takes into

account trend information pertaining to underlying default and delinquency statistics in projecting future cash flows. It's also important to understand how a target determines if securities are underwater or have been deemed "other than temporarily impaired." Factors surrounding impairment decisions may suggest how the target believes certain securities will perform over time or provide useful insights into the target's projections with regard to liquidity and cash flow sources.

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## 3: Capital challenges

Historically, excess capacity stemming from excess capital has driven the insurance pricing cycle and influenced the level of M&A activity in the P&C sector. In the short term, primary focus among P&C companies has shifted from excess capacity issues to raising capital in an effective and efficient manner in order to fund holding company losses. In the long term, however, history suggests that the P&C industry will return to an excess capital position wherein deploying excess capital effectively will once again be a primary challenge. To deploy capital effectively, insurance companies have three primary options: write more business, return capital to shareholders and/or policyholders, or acquire another company or business. To reduce the historical cyclical nature of the insurance business, however, the insurance industry needs to consider developing better tools to access and subsequently redeploy capital.

M&A transaction activity in the U.S. insurance industry typically stems from three key factors dealing with the industry's structure: first, the U.S. insurance market remains highly fragmented despite decades of consolidation; second, both P&C and life & health insurance are slow-growth businesses; and third, the U.S. insurance industry has historically had substantial excess capacity. Each of these factors is a primary stimulus for M&A activity. In addition, although excess capital may not be an industry-wide issue in the short term, it will likely be so once again in the long term.

Although the entire U.S. insurance industry tends to be overcapitalized, the related challenges for the P&C industry, in particular, are especially difficult. During the years 2006 and 2007, the P&C industry enjoyed some of the most profitable years in its history. The downside to all of this underwriting profitability was excess capital formation. As a result, many insurers struggled with a surfeit of capital and searched for ways to deploy it effectively. To do so, insurance companies have three basic choices: write more business, return capital to shareholders and/or policyholders, or acquire another company or business.

As the current soft market reflects, the entire P&C industry is aggressively attempting to write more business. In addition, some companies are actively returning capital to shareholders or policyholders via share buy-backs and dividends. The acquisition of Safeco by Liberty Mutual is a perfect example of how excess capital can be deployed via acquisition. As a cash transaction, the Liberty Mutual/Safeco deal removed a substantial amount of capital from the P&C industry and allowed it to be redeployed elsewhere.

Over the long term, however, none of these activities are going to make much of a dent in historically high, industry-wide levels of excess capital. Nor will admittedly useful capital management tools do much to help the insurance industry regain control of its capital base. If the industry is to significantly reduce the historic cyclicalities of the insurance business, it should consider finding better ways to access and subsequently redeploy capital.

Perhaps there are lessons to be learned from the reinsurance industry, which has made some progress toward creating vehicles for raising capital and returning it on a relatively short-term basis. To this point, catastrophe bonds and sidecars were very effective during the last hard market. These vehicles helped the reinsurance industry reduce volatility during a challenging period and will likely be of even greater value when they are refined further.

The primary insurance industry could be well served by the design of similar vehicles for capital management. Until such time as the industry develops the tools necessary to manage its capital base more effectively, however, it will likely continue to struggle with hard- and soft-market cyclicalities.

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## 4: Low valuations

Toward the end of 2008, many P&C companies took substantial financial hits from investment losses and catastrophe-related losses experienced during the third quarter. Reflecting weaker balance sheets and lower reserve levels, the valuations of many P&C firms are trading at discounts to book value and, in some cases, at all-time lows. At the same time, many life companies have suffered sizeable investment losses as well as ratings downgrades and now find themselves trading at discounts to book value if not all-time lows. As a result of these financial setbacks, a good number of P&C and life companies face a need to consider their merger options in order to increase capital and diversify risks.

Historically, as the pricing cycle for insurance premiums deteriorates or softens, M&A activity tends to increase. At the start of 2008, there was “noise” in the insurance market that seemed to be pointing to a potential increase in M&A activity as market pricing continued to deteriorate. In 2009, the P&C and insurance brokerage market segments are likely to get the most consideration for an increase in M&A activity. Although these markets experienced a slight increase in deal activity during 2008, this activity was largely confined to consolidation among smaller companies.

According to analysts, some P&C companies still appear to have strong balance sheets as well as ample financial reserves. These indicators of financial strength, coupled with modest catastrophic (CAT) losses in recent years, have armed these P&C companies with the financial wherewithal to make acquisitions. In addition, pricing

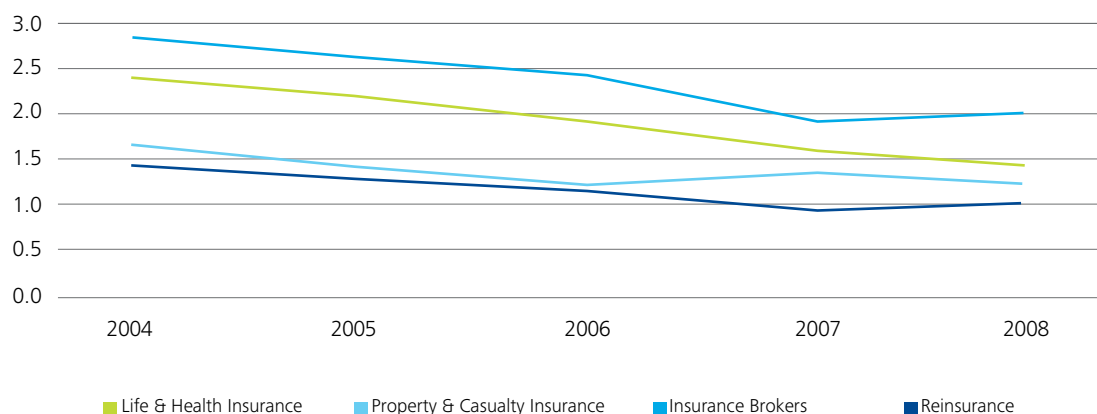
within the P&C market may soften further as the current economic downturn continues. Thus, analysts and other market observers believe that P&C companies may be more inclined to grow by acquisition than to expand their books of business organically. This viewpoint reflects the knowledge that growing business organically in a soft market is typically accomplished by cutting prices further, a potentially unprofitable tactic.

To gain further insight about the current insurance M&A environment, please refer to Exhibit 1. As illustrated, certain publicly traded P&C companies have been trading (price/book) below 2004 levels, with the most current information suggesting a price/book multiple of approximately 1.2x for P&C companies.

Within the insurance brokerage market segment, private equity firms have purchased a number of insurance brokers in the recent past. This market segment could remain attractive to would-be acquirers for three reasons: first, share prices of insurance brokers continue to be

depressed; second, brokers are typically not vulnerable to credit issues; and third, brokers have low leverage. In addition, brokers also have the potential to provide access to a steady flow of cash, although this attribute tends to be weakened in a soft market.

**Exhibit 1:** Price to Book Value Multiples, Global Sample of Public Insurance Companies



	2004	2005	2006	2007	2008
Life & Health Insurance	2.4	2.2	1.9	1.6	1.4
P&C Insurance	1.7	1.4	1.2	1.3	1.2
Insurance Brokers	2.8	2.6	2.4	1.9	2.0
Reinsurance	1.4	1.2	1.1	0.9	1.0

Source: Capital IQ, January 6, 2009.

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## 5: Integration challenges

Strategic acquirers are increasingly taking more of an “all or nothing” approach to integration whereby they are either buying an entity and leaving it alone or moving quickly to integrate the entity into their operating platform. This pattern is a noteworthy departure from the “merger of equals” mentality of past years characterized by active attempts to identify and preserve the best of both predecessor organizations into the new, combined entity. M&A “clean teams” are helping to speed up the merger process by enabling intended merger partners to share proprietary information while mergers are still awaiting regulatory approval.

Strategic players, who have taken the lead from the private equity sector on the M&A front, are increasingly taking more of an “all or nothing” approach to integration. In doing so, they are either buying an entity and leaving it alone (more or less) or they are moving quickly to integrate, or assimilate, the entity into their operating platform. This pattern is a noteworthy departure from the “merger of equals” mentality of past years characterized by active attempts to identify and preserve the best of both predecessor organizations into the new, combined entity.

Regulators also appear to be scrutinizing deals more closely, perhaps because of reduced deal volumes and increased pressure to protect consumers. In addition, staff shortages at regulatory agencies appear to be slowing down the regulatory approval process. On a combined basis, these two trends could make regulatory approvals more difficult to secure. In such an environment, using M&A “clean teams” to speed up the pre-close integration process can provide significant advantages.

By employing clean teams, intended merger partners can share proprietary information, and develop integration

plans based on that information, while mergers are still awaiting regulatory approval. They can help integrate people, products, processes, systems and distribution channels – all crucial to deriving anticipated merger synergies. They can use predictive modeling to segregate individual risks into their expected risk profiles. And they can help merging organizations plan for an issue-free Day One and provide a three to four month jump on realizing deal value. To increase their speed and efficiency, best practice clean teams are using Web portals to share files and information among the dozens or hundreds of people who can potentially be involved in a major deal.

It should be noted that legal counsel should always be consulted prior to establishing a clean time as there are various SEC and legal requirements that must be complied with.

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## 6: Changes in insurance company regulation

The economic crisis gripping financial services companies in the United States and abroad could spur passage of the most sweeping set of regulatory reforms since the 1930s. In the U.S., proposals to create a federal regulatory framework to cover insurance companies as well as other types of financial institutions are expected to receive serious consideration. The widespread perception that major regulatory reforms are inevitable suggests that participants in the insurance M&A arena stay abreast of potential regulatory changes when evaluating potential transactions. For useful background, consult the *Blueprint for a Modernized Financial Regulatory Structure*, which sets forth the former Bush Administration’s views on what is needed to update and modernize the regulatory framework for banks, insurance companies and other types of financial institutions.

Reform of the financial services industry is a near certainty in the 111th Congress. Today’s financial crisis, coupled with Democratic majorities in the House and Senate and a president eager to pursue regulatory change, will likely lead to the most significant restructuring of financial services regulations since the Glass-Steagall Act created a

wall between commercial and investment banking in 1933. Projected regulatory changes, no matter what their final form, will likely lead to increased scrutiny of the insurance industry and fundamentally alter the operating landscape for insurance companies.

Last March, the U.S. Treasury Department unveiled a proposal to create an Optional Federal Charter for Insurance to “provide more effective, efficient, and consistent regulation for national insurers.” The current economic situation will likely only serve to increase the federal appetite for providing national oversight of the insurance industry. The proposal, if enacted, would significantly affect state and federal regulators as well as insurance companies, agents and consumers.

The debate over potentially creating an Optional Federal Charter for Insurance may well be resolved by the deletion of the word “optional.” Doing so could lead to some form of federal oversight of insurance companies over and above the current system of state-based regulation. Some observers foresee creation of an Office of Federal Insurance Regulation in the Treasury Department, similar to the plan outlined in the “Blueprint for a Modernized Financial Regulatory Structure” put forward in March of 2008 by Treasury Secretary Paulson. That plan – which would address systemic risk as well as retain elements of the existing state-by-state regulation of the insurance industry – would create a super federal regulator for all U.S.-based financial services entities modeled after the Financial Services Authority in the United Kingdom. Thus, it is highly advisable for serious players in the insurance M&A arena to study the Paulson Blueprint as we await the actions of the new Administration and Congress.

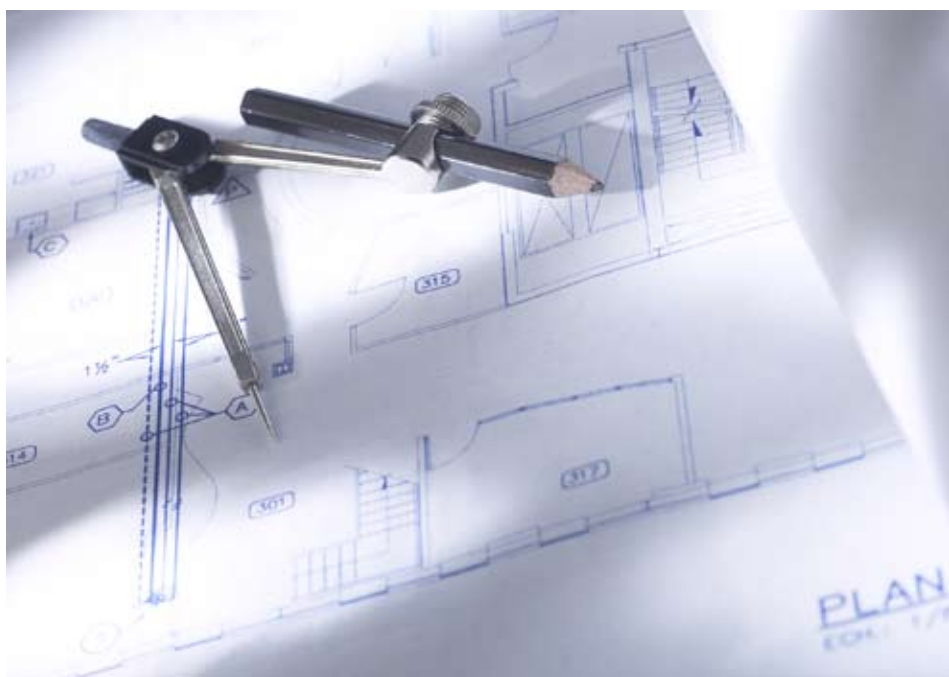
The U.S. Treasury Department, in a fact sheet outlining the Blueprint, stated that “Insurance regulation is almost wholly state-based, with 50+ regulators,” a structure that raises a number of issues with respect to efficiency and cost. To address such structural concerns, Treasury recommended creation of the Optional Federal Charter for Insurance “to encourage a more competitive industry” and to “provide more effective, efficient, and consistent regulation for national insurers.”

In outlining its proposal, the Treasury Department said it was recommending the establishment of a federal insurance regulatory structure to provide for the creation of an Optional Federal Charter with a structure similar to that of the current dual chartering system for banking, which involves both national and state oversight. Oversight of the Optional Federal Charter would be provided by an Office of National Insurance within the Treasury Department. As an interim measure, Treasury also recommended establishment of a federal Office of Insurance Oversight within Treasury to establish a federal presence in insurance covering both international and regulatory issues.

A host of parties would be affected by any significant changes to the current regulatory framework for the insurance industry – from state regulators and the Treasury Department to insurance companies, agents and consumers. And opinions vary widely with regard to what form insurance regulation should take. In all likelihood, states would fear loss of control and revenue from the proposal while national insurance companies would find regulatory uniformity to be highly advantageous. At the same time, regional insurance companies might find it hard to give up a regulatory environment that they have found to be accessible as well as local.

From an insurance M&A perspective, it is too soon to assess the potential implications of a federal regulatory framework covering insurance companies along with other types of financial institutions. However, the widespread perception that some change is likely suggests that participants in the insurance M&A arena stay abreast of potential regulatory changes when evaluating potential transactions.

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## 7: Push for IFRS

Globally, there is a clear movement toward a single financial reporting standard, IFRS, to replace local country GAAPs (Generally Accepted Accounting Principles). A switch to IFRS would establish a globally accepted insurance accounting standard. It could also result in more consistent financial information and valuations – both key benefits to players in the insurance M&A arena.

On a global basis, there is a clear movement toward a single financial reporting standard, IFRS (International Financial Reporting Standards), to replace local country GAAPs (Generally Accepted Accounting Principles). Many observers now believe the shift from U.S. GAAP to IFRS is just a matter of time. For U.S.-based insurance companies, the shift will provide an opportunity to see how their numbers stack up against their overseas counterparts that apply IFRS.

The perceived benefits of a mandated switch from GAAP to IFRS are many. It could improve accounting and reporting efficiencies, simplify cross-border acquisitions, and increase transparency for all investors. Eventually, it may also reduce accounting costs. However, IFRS does pose some legitimate concerns. For instance, the International Accounting Standards Board (IASB) has yet to develop industry standards in certain limited areas in which IFRS permits disparate options. One such area identified by the IASB as lacking standards: insurance contracts.

In May of 2007, the IASB issued a Discussion Paper, *Preliminary Views on Insurance Contracts*, which contains preliminary views on the various recognition and measurement components considered in accounting for insurance contracts and identifies issues that are still under consideration. In August of 2007, the Financial Accounting Standards Board (FASB) issued an invitation for comment on the Discussion Paper to assess whether there is a need for a project on accounting for insurance contracts, and whether FASB should work with the IASB in a joint project. In October 2008, the FASB announced the addition of this project to its agenda.

A new International Financial Reporting Standard (IFRS 4 Phase II) for insurance companies would, if adopted, require fundamental changes in how insurers report their insurance contracts. In particular, it would introduce a fair value-like approach to valuing liabilities for insurance and reinsurance contracts by establishing a single measurement model for insurance contracts across life insurance, P&C insurance, health insurance and reinsurance based on a form of “fair value.” Currently, differences in insurance accounting standards between countries are material, which makes it difficult to use financial statements to compare insurers across borders and to understand the financial results of insurance companies that operate in multiple countries.

In the meantime, the Securities and Exchange Commission (SEC) has approved rule amendments under which financial statements from foreign private issuers in the U.S. will be accepted without reconciliation to U.S. GAAP. In a related action, the SEC issued a proposed roadmap on allowing U.S. issuers to prepare financial statements in accordance with IFRS, and the FASB completed its business combination convergence project with the releases of Statement of Financial Accounting Standards (SFAS) No. 141 (revised 2007) *Business Combinations* and International Financial Reporting Standard (IFRS) 3 *Business Combinations* (2008).

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### How IFRS could benefit insurance M&A

- **Common standards:** For multinational insurers, IFRS would mean the establishment of a globally-accepted insurance accounting standard.
- **Improve process quality:** Increased transparency, information quality and consistency in the definition and accounting treatment of insurance contracts may enable better screening and due diligence into target companies using IFRS. In addition, the use of XBRL will further enhance transparency, information quality and comparability across companies and across countries.
- **More consistent valuations:** IFRS shareholder equity is likely to represent a more consistent starting point for valuing a company than using book value under U.S. GAAP.
- **Greater access to foreign capital:** Firms seeking capital for M&A deals may find that reporting under IFRS will provide greater access to foreign capital markets (e.g., European or some Asian markets).
- **Financial information:** IFRS could provide creditors and investors with a clearer picture of an insurance company’s risks and cash flows, thus facilitating more appropriate financing arrangements.
- **Reduce operating costs:** From an integration perspective, the use of a single financial reporting standard could reduce global operating costs and facilitate the centralization of accounting systems. In some cases, the ability of insurers to use IFRS for both financial and statutory reporting will likely further reduce costs.

## 8: Principles-based reserves

The National Association of Insurance Commissioners (NAIC) is expected to adopt new regulations for determining statutory insurance reserves and minimum capital levels that may fundamentally change the way that insurance companies are valued. These new measures – often referred to as the Principles-Based Approach (PBA) to reserve and capital requirements – will require companies to “model all identifiable and material risks, benefits, and guarantees inherent to the product sold.” They will have a significant impact on the due diligence associated with M&A transactions by requiring companies to test and understand the reasonableness of the assumptions used in the models.

PBA will enable insurance companies to appropriately align their reserves and capital with the risks they face, providing a competitive advantage to companies that actively manage their risk profiles. Current regulations, based on a one-size-fits-all formulaic approach, require many companies that are actively managing their risk profiles to hold redundant reserves and capital. Of note, the new regulations will not impact in-force business.

Under a PBA to reserve and capital requirements, companies will need an increased capacity to monitor results, explain financial impacts, analyze trends and review controls. For such a wide-sweeping change in liability generation, systems and processes across a company will need to be reviewed and adjusted to handle the potentially new data formats, computation demands, and reporting

requirements. The changes will impact a company’s pricing process, ALM process, valuation processes, and risk-review process.

Certain aspects of PBA are already in place (primarily those concerning the derivation of risk-based capital amounts for variable annuities) but the date for required conversion to full PBA has yet to be set. Full implementation of PBA within a company could take two or more years. Once PBA is implemented, companies may be hard-pressed to meet their current monthly or quarterly financial-reporting timelines.

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## 9: Fair value reserving

*Fair Value of P&C Loss Reserves under Purchase Accounting* – The underlying principle of fair value accounting under SFAS 141(R) is that an acquirer needs to evaluate loss-reserve obligations using valuation assumptions that are consistent with those that would be used in a public market exchange. In practice, two general approaches have emerged to determine the fair value of P&C loss reserves. The *direct* method involves discounting the expected value of loss reserves using a risk adjusted discount rate. The *indirect* method separately identifies the risk margin from the discount rate used in the fair value calculation.

The underlying principle of fair value accounting is that an acquirer needs to evaluate loss-reserve obligations using valuation assumptions that are consistent with those that would be used in a public market exchange. However, such a liquid market does not readily exist for loss reserves. Commutation pricing may or may not be applicable as many of those transactions are done under duress and market comparisons are not readily available.

The key components of the loss-reserves valuation include the expected (nominal) value of liabilities, a discount rate and a risk margin that is commensurate with the inherent risk in the estimation process, and the timing of the payments.

In practice, two general approaches – the *direct* method and the *indirect* method – have emerged to determine the fair value of P&C loss reserves.

The *direct* method involves discounting the expected value of loss reserves using a risk adjusted discount rate. The risk-adjusted discount rate is one that the market would require to assume the cash flows and the risk inherent in the timing and amount of the payments in the expected loss reserves. In practice, the risk-adjusted discount rate will be less than the risk-free rate of equal duration to the liabilities. It is possible to have a negative discount rate if the implicit risk margin associated with the variability of the cash flows exceeds the assumed investment earnings rate. It is important to note that the risk-adjusted discount rate would vary by line of business.

The *indirect* method – which uses a two-step process as compared to the direct method – separately identifies the risk margin from the discount rate used in the fair value calculation. The typical discount rate used is the duration-matched yield of the risk-free rate with the expected loss-payment pattern. Various methods have been utilized to derive the risk margin for the loss reserves. For additional information about the risk margins and fair value, refer to the Casualty Actuarial Web site ([www.casact.org](http://www.casact.org)).

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## 10: Tax issues & legislation

On November 4, 2008, the nation voted to hand over to President Barack Obama and a strengthened Democratic Congress a seemingly intractable set of long-term budget and tax challenges that need to be addressed. Given this situation, the tax agenda for 2009 and 2010 will likely focus first on tax cuts for economic recovery and then take up tax proposals designed to address longer-term issues ranging from the expiration of the Bush tax cuts to the growing demand for more fundamental changes to our tax system.

As we look ahead to legislative prospects in 2009, the policy decisions to be made by President Barack Obama and the 111th Congress will do much to determine the country's fiscal and economic course going into the next decade. During 2009 and 2010, the tax agenda is likely to unfold in two distinct phases:

- Phase I would focus on tax cuts and other measures designed to stimulate the economy (the nearly \$790 billion tax and spending stimulus package signed into law February 17, 2009 appears to go far in accomplishing the goals set out by the President).
- Phase II would focus on tax proposals designed to address longer-term issues such as the looming expiration of the Bush tax cuts and growing demands for a major overhaul of the federal income tax system.

In addition to targeting these two high-priority areas, however, the President and members of the 111th Congress will need to address the tax-related impact of a number of other key factors including the ongoing wars in Afghanistan and Iraq, fluctuating interest rates, mounting budget deficits, and the status of entitlement spending.

*Two key pieces of tax legislation of particular interest to the insurance industry were extended through 2009 via the Emergency Economic Stabilization Act of 2008 – first, the subpart F exception for active-financing income, and second, the look-through treatment of payments between related controlled foreign corporations:*

- **Exception under Subpart F for Active Financing Income** – The U.S. parent of a foreign subsidiary engaged in a banking, financing, or similar business is eligible for deferral of tax on such subsidiary's earnings if the subsidiary is predominantly engaged in such business and conducts substantial activity with respect to such business. The subsidiary must pass an entity-level income test to demonstrate that the income is active income as opposed to passive income.
- **Look-Through Treatment of Payments between Related CFCs under the Foreign Personal Holding Company Rules**. The rules allow deferral for certain payments (interest, dividends, rents and royalties) between commonly controlled foreign corporations (CFC). This provision allows U.S. taxpayers to deploy capital from one CFC to another without triggering a U.S. tax obligation.

In terms of priorities, the current economic situation may force the Obama administration to put comprehensive tax reform on the back burner because of the need to address other urgent issues. Irrespective of how conflicting priorities are managed, however, three tax themes are likely to predominate in the 111th Congress:

- First, targeted tax relief will be proposed early in the new administration as part of legislative efforts designed to encourage economic recovery. This has already occurred as President Obama signed into law February 17, 2009, the American Recovery and Reinvestment Act of 2009 – a nearly \$790 billion tax and spending stimulus package.
- Second, later in 2009, as Congress and the White House confront the need to extend a variety of expiring individual and business tax provisions as well as provide for additional AMT (alternative minimum tax) relief, the ballooning deficit projections associated with the current economic crisis and recovery efforts will likely make President Obama and Democratic lawmakers much less sympathetic to pleas that tax-relief provisions be extended without being accompanied by offsetting tax increases.
- Third, by 2011, President Obama and Congress will likely have raised ordinary income tax rates as well as capital gains and dividend rates on the highest income individuals.

On the all-important issue of tax reform, lawmakers are likely to consider a variety of proposals over the next several years. Likely topics for discussion include replacing the current system of taxation with some sort of value-added tax; broadening the tax base by eliminating certain business tax preferences in exchange for a lower corporate tax rate or faster write-offs of business investments; and making targeted changes to the current tax system. As the tax-reform debate moves forward and specific proposals emerge, it will be important from an M&A perspective for potential acquirers to determine their best- and worst-case tax scenarios and prepare valuation models under these scenarios. Potential changes in the tax system and tax rates can have a significant impact on the after-tax cash flows and value of the deal.

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