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THE NEWSLETTER OF THE BDO INSURANCE PRACTICE

INSURANCE ADVISOR

MID-YEAR FINANCIALS: HOW DID THE U.S. INSURANCE INDUSTRY FARE?

By Imran Makda

After a relatively quiet year for significant losses in 2013, analysts expected that 2014 would be a more difficult year for the insurance industry. Halfway into the year, the prediction of weaker results is largely coming to fruition on the property-casualty (P&C) side of the business. On the contrary, the health sector experienced significant growth with respect to premiums, while conditions in the life sector remained relatively stable.

PROPERTY-CASUALTY

Brutal winter weather in the U.S. set the tone for the year, with damage from the extreme cold and severe storms in both the winter and spring driving an influx of claims for P&C insurers in the first half of 2014. Three major weather events – one in January and two in May – generated $5.4 billion in catastrophe losses, according to Swiss Re's *sigma* database. Loss and loss adjustment expense (LAE) incurred for the P&C sector in the first six months totaled $169 billion, up 6.6 percent from the same period last year. Year-over-year net income dropped nearly 18 percent during the six-month period to $26.6 billion, from $32.4 billion last year.

In comparison to the relatively calm first half of 2013, net underwriting gains fell dramatically by more than 65 percent to $1.1 billion at the end of June 2014, from $3.2 billion during the same period last year. Underwriting gains were also affected by

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DID YOU KNOW...

According to a recent ***LIMRA*** study, only 46 percent of middle market consumers own individual life insurance.

Moody's Investors Service reports that a strong capital base and improved profitability will lead to increased competition among P&C insurers during the remainder of 2014.

According to ***Towers Watson***, commercial insurance prices increased three percent in the second quarter of 2014, following several quarters with increases over six percent.

A global survey from ***Morgan Stanley*** and ***BCG*** reports that technology disruption is poised to have a great impact on P&C insurers, forecasting a move from actuarial risk assessment using statistical techniques to structural risk modeling based on real-time observations.

Three major U.S. weather events – one in January and two in May – generated $5.4 billion in catastrophe losses, according to ***Swiss Re's sigma database***.

According to the ***Insurance Information Institute's 2015 International Insurance Fact Book***, life and nonlife insurance premiums accounted for 6.3 percent of world GDP in 2013.

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the prior year's reserve releases, which were moderately lower this year for the six-month period. Still, reserve development remains favorable. There was a slight dip in overall loss reserves for the six-month period to $596.6 billion from $596.7 billion at the end of 2013. Capital and surplus increased by two percent to $678.6 billion for the first six months of 2014, from $665.2 billion at year-end 2013.

Both net and direct premium written were trending upward. Economic growth generally has a positive influence on premiums and key economic indicators, such as new vehicle sales, multi-unit residential construction, employment and payroll, are showing signs of strength. Net premium written was up 3.9 percent year over year, totaling $247.9 billion at the end of June 2014. Direct premiums written were up 5.1 percent during the six-month period.

The expense ratio remained relatively consistent at 28.7 percent, compared with the past five years. However, the six-month loss ratio rose slightly to 70.8 percent from 69.3 percent during the same period last year due to the reasons described above. The combined ratio for the industry was at 99.45 percent at the end of June.

▶LIFE INSURANCE

In the life insurance sector, the overall financial results for the first half of the year showed slight deterioration. The life industry's net premiums and annuity considerations soared, hitting a record $335.5 billion at the end of the second quarter of 2014. However, this increase was grossly inflated by $40.5 billion in premiums and considerations solely attributable to the U.S. life subsidiaries of The Hartford Financial Services Group Inc. The Hartford terminated its coinsurance and modified coinsurance agreements with an affiliated entity. When excluding results for Hartford, the industry's growth rate drops to a modest 5.25 percent increase.

Net investment income also rose slightly this year to $84.4 billion for the six-month period from $82.7 billion in 2013. Another bright spot for life insurers was the year-over-year net realized losses, which dropped dramatically to $605 million for the first half of the year, a nearly 90 percent improvement over the $5.9 billion loss reported last year. This was due to normalizing credit spreads and further stabilization of the financial markets in general.

The premium growth was offset by surrenders and benefits, both of which saw year-over-year increases for the six-month period, with surrenders jumping 9.9 percent; benefits increasing by 3.2 percent; and an increase in reserves and deposits of 61.2 percent. Total policy reserves increased by $42 million, or two percent, at $2.63 trillion compared to $2.59 trillion at the end of 2013. Capital and surplus was up four percent to $346 billion at the end of June, compared with $332 billion at year-end 2013.

As a result, the overall net income trended downward; whereby it fell by 8.1 percent for the six-month period to $20.9 billion from $22.8 billion in 2013.

▶HEALTH INSURANCE

To date, the Affordable Care Act continues to have a positive impact on premium growth for health insurers, with net premium written and new members continuing to rise. At the end of June, net premium written was at $251.5 billion, up 15.2 percent over the same period last year. Total members stood at 268.3 million for the first half of the year, compared to 248.1 million at the end of 2013. Health insurers also saw a slight improvement in capital and surplus, which was at $144.2 billion for the six-month period compared to $143.9 billion at year-end 2013.

The expense ratio was up to 12.47 percent at the end of June, from 9.48 in the first half of 2013. The medical cost ratio dipped slightly from last year during the six-month period to 88.6 percent. The year-over-year combined ratio for the period rose to 101 percent this year, from 98.56 percent last year. The increase in combined ratio resulted in net underwriting gain of $7.3 billion for the first six months of 2014; a decline of $2.5 billion or 25 percent compared to the same period in 2013. This contributed to overall decline in net income of 39 percent for this sector to $5.4 billion for the six months ended June 30, 2014, compared to 2013.

▶M&A ACTIVITY

The deal market has been hot in general this year, but activity in the insurance sector has been slow and steady. A recent SNL Financial article on global insurance M&A activity during the second quarter points to insurers taking "smaller, shrewder steps toward building out their business," focusing more on strategy than scale. Below is a summary of deal activity (as of 8/29/14) based on SNL's M&A activity tracker:

	2012	2013	2014 Year to Date
Number of Deals	97	79	41
Life & Health	31	24	7
Managed Care	16	13	6
Property & Casualty	50	41	28
Total Deal Value ($M)	17,021.11	5,710.88	9,681.94
Life & Health	4,197.03	3,827.12	5,834.86
Managed Care	10,928.25	280.71	23.00
Property & Casualty	1,895.83	1,503.06	3,824.08

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While there were fewer deals during the second quarter than last year, deal volume for the first eight months of the year was up significantly, standing at more than $9.6 billion, according to SNL Financial data. The year has seen several billion-dollar insurance acquisitions that drove up volume, the largest of which hit in June when Japan-based Dai-ichi Life Insurance Co. Ltd. announced its purchase of Protective Life Corp. for approximately $5.6 billion. Another highlight was the purchase of Wilton Re Holdings by an investor group for $1.8 billion.

Low interest rates in the U.S. are prompting deals, with life insurers eager to offload annuity units that are being hit hard by the low-interest rate environment, according to *The Wall Street Journal*'s "Moneybeat" blog. However, the volume of deal making activity has slowed down considerably in this sector compared to the previous two years. On the P&C side of the business, SNL Financial reports the focus has been on organic growth, with specialty businesses in high demand. Companies are generally looking for targets that are a good strategic fit from an operational standpoint. Another bright spot in P&C is the workers' compensation sector, where pricing has remained strong, making it an attractive target for deals this year.

For more information, please contact Imran Makda at imakda@bdo.com.

UPDATES FROM THE NAIC SUMMER 2014 NATIONAL MEETING

By Richard Bertuglia

The National Association of Insurance Commissioners (NAIC) held its 2014 Summer National meeting in mid-August. Several significant items related to corporate governance and accounting were discussed, adopted or exposed at the meeting.

Corporate Governance Highlights

The Corporate Governance Working Group adopted the Corporate Governance Annual Disclosure (CGAD) Model Act and the Corporate Governance Annual Disclosure Model Regulation to provide annual information on an insurer's corporate governance practices to insurance regulators. An insurer, or the insurance group of which the insurer is a member, is required to file a CGAD no later than June 1 of each calendar year that contains the following information:

- description of the insurer's or insurance group's corporate governance framework and structure;
- description of the policies and practices of the most senior governing entity and significant committees;
- description of the policies and practices for directing senior management; and
- description of the processes by which the board, its committees and senior management ensure an appropriate amount of oversight to the critical risk areas impacting the insurer's business activities.

The insurer or insurance group shall be as descriptive as possible in completing the CGAD, with inclusion of attachments or example documents that are used in the governance process, since these may provide a means to demonstrate the strengths of their governance framework and practices. The first filing will be required in 2016.

Accounting Highlights

There were two items exposed by the Statutory Accounting Principle Working Group (SAWG) that could have a substantive impact on statutory reporting requirements:

Statement of Cash Flows

Various discussions were held on how to address non-cash items in the statement of cash flows. NAIC staff has received information that the statutory guidance in *Statutory Statement of Accounting Principle (SSAP) No. 69 – Statement of Cash Flows* is unclear regarding the inclusion or exclusion of non-cash items, which may result in inconsistencies in the preparation of the cash flow statement. The SAWG is recommending that NAIC staff request information from reporting entities and regulators on preferences and current industry practices related to the presentation of the cash flow statement. The NAIC staff also was directed to conduct an anonymous survey of state regulators to understand how they use the cash flow statement.

Heath Insurance Reinsurance, Risk Adjustments and Risk Corridors

The SAWG directed NAIC staff to redraft the exposed *Issue Paper (Ref # 2014-12) – Accounting for the Risk-Sharing Provisions of the Affordable Care Act* to remove the previously exposed guidance that requires the non-admission of Affordable Care Act-related receivables not received within 90 days. The revised guidance is consistent with other government receivables that are not subject to the 90-day rule.

For more information, please contact Richard Bertuglia at rbertuglia@bdo.com.

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SEAL THE DEAL: THE CFO'S ROLE IN MINIMIZING POST-ACQUISITION DISPUTES IN THE INSURANCE INDUSTRY

By Jeffrey M. Katz, CPA/ABV, CFF, CFE, and Susanne Cleary, CPA, CFE, BDO Consulting

Merger & Acquisition (M&A) activity in the insurance industry increased approximately 20 percent during the first six months of 2014 when compared to the same time period in 2013, according to SNL Financial. With private equity firms expected to become active in transactions involving the property & casualty and life insurance subsectors, deal volume could increase even further during the second half of the year. Given the increase in M&A transactions in the insurance industry, it is important for CFOs involved in such transactions to understand the post-acquisition dispute issues that often arise after closing. CFOs who proactively consider common causes of post-acquisition disputes before an agreement is reached can minimize the chances of being distracted with such post-closing issues and instead focus on integrating the newly acquired business, driving operational efficiency and setting the company on a path for growth.

PErspective in Insurance

All eyes are on New York this fall as the state considers regulatory changes that would place additional requirements on those applying for approval of insurance company buyouts. The proposed changes would both increase the burden of the pre-deal approval process and regulate post-takeover activities, according to Law360 – a move some see as threatening private equity investors' growing interest in the insurance sector.

The potential for increased PE investment is attributed by multiple sources and surveys to an improving economy, to international investors' need to diversify by class and by geography, and to PE firms' confidence in their abilities to improve the returns of companies that traditionally have invested very conservatively.

It's that confidence in increasing returns, and those investment strategies, that have regulators sharpening their pencils as PE firms step up their insurance industry games. Yet, according to an August 2014 *Institutional Investor* article, PE firms "more and more are seeking singles and doubles," not home runs. The annuities market has piqued their interest, in particular, for its ability to provide not a quick profit, but the potential for steady growth and returns as baby boomers switch to more stable retirement options.

In August, rating agency A.M. Best told NAIC's Private Equity Issues Working Group that a recent survey indicated the increased flow of private equity funds into the insurance industry has had no impact on the majority of individual companies' strategies. Indeed, some say the annuities market could lose out should regulation drive away PE capital. With their lower profit margins, the infusion of capital and investing expertise from private equity firms may be helping to stave off credit downgrades.

The Private Equity Issues Working Group continues to solicit feedback from PE firms investing in the insurance industry, some of whom have already stated that they have no issues with increased regulation so long as it is applied industry-wide.

PErspective in Insurance is a feature examining the role of private equity in the insurance industry.

M&A agreements often contain a post-closing adjustment to the purchase price, which is intended to reflect differences in the balance sheet of an acquired company between the date a deal is negotiated and the date the transaction closes. While the metrics for adjustments vary from one agreement to the next, adjustments are often based on the change in a business's Net Working Capital, Net Assets and/or Company Debt. Disputes often arise because the parties to an M&A agreement have differing opinions regarding the amounts that should be recorded on the closing balance sheet. In the insurance industry, these disputes often focus on the application of Generally Accepted Accounting Principles (GAAP) or the National Association of Insurance Commissioners, Statement of Statutory Account Principles (SSAP), within the context of the terms of the M&A agreement.

For example, M&A agreements may contain language that requires the closing date balance sheet be prepared in accordance with GAAP and consistent with a company's past policies, practices and procedures. Post-closing purchase price adjustment disputes often arise when a company's past practice is not in accordance with GAAP and the M&A agreement is silent on which should prevail – past practices or GAAP. CFOs can play an important role in minimizing transaction disputes by suggesting clarifying language in the agreement that specifies which methodology takes precedent. If the parties' intent is that the closing date balance sheet be prepared consistent with past policies, practices and procedures, then the parties should consider not including any reference to GAAP in the M&A agreement provision that discusses the preparation of the closing date balance sheet.

Another challenge that often arises is related to differing assumptions made by a buyer's and seller's management team. As CFOs are aware, GAAP and SSAP require management to make judgments and estimates in preparing

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financial statements. However, in an M&A transaction, buyer management and seller management might have differing estimates for the same balance sheet item, even when both estimates are in accordance with the technical requirements of GAAP or SSAP.

For example, SSAP requires an insurer to record an acquired security at amortized cost and continue to evaluate the security to determine whether it is impaired and, if so, whether the impairment is other than temporary. In making such an evaluation, it is necessary for management to make judgments and estimates about the future cash flows to be received from the security. In some transactions, the buyer's assessment of such securities indicates the security is impaired, while the seller's assessment is that the amortized cost is recoverable. As a result, such items can be the focus of post-acquisition dispute claims. CFOs involved in an M&A transaction in the insurance industry may want to suggest the inclusion of language in the agreement that removes the subjective nature of such estimates. One solution might be for the parties involved in the transaction to agree on a formula to test the impairment of acquired securities.

In addition to net working capital adjustment provisions, many M&A agreements contain earn-out provisions intended to bridge the differing views on the value of a business between the buyer and the seller. Because these provisions frequently have a financial-related metric that needs to be achieved in order for the additional purchase price to be paid, it is important to be aware of changes in GAAP that could impact an earn-out calculation. For example, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) recently issued new revenue recognition guidance that is intended to provide information in financial statements about the nature, timing and uncertainty of revenues from contracts with customers. While most of the changes do not go into effect until 2017, CFOs should be aware of how these changes might impact current M&A transactions. Because earn-out targets are often based on historical financial performance projected for future performance, the revenue recognition changes can result in future financial targets being established according to current guidance, even though the actual future financial results will be calculated using the new revenue recognition standard. This inconsistency could result in post-acquisition disputes because the seller may or may not earn contingent consideration solely due to a change in GAAP and not the underlying performance of the company. CFOs can add value to the deal team by making sure that changes in GAAP are taken into account when setting the earn-out targets.

Understanding that M&A agreements are subject to interpretation and disagreement between the buyer and seller, CFOs can provide crucial guidance to those negotiating the terms of an agreement to help minimize post-acquisition disputes and the resulting impact on the value of acquired businesses.

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NEW CO-LEADERS OF THE BDO NATIONAL INSURANCE PRACTICE

Imran Makda

Barb Woltjer

BDO has appointed New York Assurance Partner Imran Makda and Grand Rapids Assurance Partner Barb Woltjer co-leaders of the national Insurance practice, effective July 1. They resumed the role previously held by Grand Rapids Assurance Partner Tom Hiller, who retired June 30. In their new role, Makda and Woltjer are responsible for continuing the growth and management of the national Insurance practice.

"Imran and Barb are essential members of our Insurance practice, and integral components to what has made the industry group so successful. We congratulate them and look forward to their continued contributions," says Industry Strategy Lead Jay Duke. "We also wanted to offer our gratitude to Tom, who was a highly effective leader. We appreciate his dedication and commitment to helping launch and grow the industry group from inception."

Based in New York, Makda has been with BDO for 18 years. He has led client service and business development efforts for BDO's national Insurance practice. Makda is responsible for training and Continuing Professional Education programs for the New York Insurance industry group.

Woltjer's career with BDO spans 26 years. Resident in the Grand Rapids office, she has been instrumental in driving the evolution of BDO's national Insurance practice, spearheading and continuing to direct and sponsor the national insurance staff training course. In addition, she assisted in the development of the firm's audit program.

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OCTOBER

October 15-16
SNL Insurance M&A Symposium
Union League Club
New York, N.Y.

October 15-17
Insurance Analytics Symposium
New Orleans Marriott
New Orleans, La.

October 19-21
ACLI Annual Conference
J.W. Marriott
Washington, D.C.

October 20-21
Women in Insurance Leadership Forum
InterContinental Chicago Magnificent Mile
Chicago, Ill.

October 26-29
PCI Annual Meeting
Westin Kierland Resort & Spa
Scottsdale, Ariz.

NOVEMBER

November 16-19
NAIC Fall Meeting
Washington Marriott Wardman Park
Washington, D.C.

November 17-19
AHIP Operations and Technology Forum 2014
Arizona Biltmore
Phoenix, Ariz.

November 18
ACETech
Westin Times Square
New York, N.Y.

DECEMBER

December 4-5
2014 Annual Insurance Executive Conference
Grand Hyatt
New York, N.Y.

BDO INSURANCE PRACTICE

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Material discussed is meant to provide general information and should not be acted on without professional advice tailored to your firm's individual needs.

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