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NAIC Private Equity Initiative – Fall 2024 Update

Update Following the NAIC November 16-19 Fall National Meeting

SUMMARY

This memorandum reviews key developments from the National Association of Insurance Commissioners (“NAIC”), primarily from its Fall National Meeting (the “Fall National Meeting”), with respect to its “private equity initiative”. Since our last update,[1] the NAIC finalized:

- an amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”), which provides discretionary authority to the NAIC Investment Analysis Office (“IAO”) to exclude certain rating agency credit ratings or remove certain securities from the filing exempt (“FE”) process, in each case if the IAO determines that the resulting NAIC Designation does not reflect a reasonable assessment of applicable risk;
- new guidance on the review of Form A applications and disclaimers of control; and
- new guidance on surplus notes and capital maintenance agreements.

While much of the NAIC’s work on its “private equity initiative” has now been completed, several key work streams will continue into 2025, including the development by the working groups indicated below of:

- a comprehensive framework for determining risk-based capital (“RBC”) factors for all tranches of collateralized loan obligations (“CLOs”) and other structured securities (*Risk-Based Capital Investment Risk and Evaluation (E) Working Group*);
- a modeling methodology for determining NAIC Designations of CLOs (*Valuation of Securities (E) Task Force*);
- a framework for performing due diligence on rating agencies whose ratings may be used by the NAIC to determine NAIC Designations – referred to by the NAIC as credit rating providers or “CRPs” (*Financial Condition (E) Committee (“(E) Committee”), with the aid of a third-party consultant*); and
- an actuarial guideline, proposed to be effective as of year-end 2025, requiring life insurance companies to use a cash flow testing methodology in performing their asset adequacy analysis

for the "Total Reserve" backing certain material life insurance and annuity reinsurance agreements entered into with non-U.S. reinsurers (*Life Actuarial (A) Task Force ("LATF")*). "Total Reserve," in this context, covers reserves held in respect of the applicable reinsurance arrangement both by the cedent and the reinsurer, but excluding reserves held by the reinsurer that are not backed by certain types of "hard" assets.

Contrary to prior periods, no updates were made to the NAIC list of 13 regulatory considerations itself.[2] In addition, no substantive revisions were made by the (E) Committee to the proposed framework for regulation of insurer investments since the framework's exposure for public comment in August 2024.[3]

DISCUSSION OF KEY UPDATES

Adoption of Proposal to Give IAO Discretion to Remove Securities from Filing Exempt Process. The NAIC Executive (EX) Committee and Plenary adopted an amendment to the P&P Manual allowing the IAO to exclude certain rating agency credit ratings, or remove certain securities, from the FE process if the IAO determines that the resulting NAIC Designation does not provide a reasonable assessment of applicable risk for regulatory purposes.[4] Review of the applicable rating or security may be initiated by a regulator or by the IAO itself—which means that IAO staff, who are not regulators, have now been provided the ability to challenge NAIC Designations subject to the FE process even in circumstances where no insurance regulator has done so. The amendment adds that the discretionary authority granted to the IAO is intended to be applied to securities rated by any of the CRPs, without any intent to favor or disadvantage any individual CRP or class of CRPs, and "is not expected to be used often". This amendment to the P&P Manual is scheduled to become effective as of January 1, 2026.

Due Diligence Framework for Rating Agencies. Following comments from interested parties, the (E) Committee released an updated version of the request for proposal ("RFP") it intends the NAIC to use to hire a consultant to design and assist with implementation of a due diligence framework for rating agencies used by the NAIC as CRPs.[5] The revisions include certain clarifications regarding the NAIC's objectives in developing the due diligence framework, including:

- The purpose of the framework is to eliminate what the NAIC describes as "blind reliance" on CRP ratings, while still enabling the NAIC to continue to use such ratings with "strong due diligence" oversight;
- The framework should include clear quantitative and qualitative parameters for rating agencies to meet in order to be used as CRPs; and
- While the IAO would retain the ability to perform individualized credit assessments and utilize regulatory discretion when needed, under "well-documented and guided parameters", this IAO authority would be a "backstop" and "ideally would be rarely used if other governance is optimized".

The (E) Committee will next present the finalized RFP to the NAIC Executive (EX) Committee for its approval, and intends to begin using the RFP to solicit bids from third-party contractors shortly thereafter.

Form A Applications; Disclaimers of Control. Between the Summer and Fall National Meetings, the NAIC Financial Analysis Solvency Tools (E) Working Group ("FASTWG") adopted revisions to the NAIC Financial Analysis Handbook amending guidance for regulators reviewing Form A applications (*i.e.*, applications to acquire control of an insurance company) and disclaimers of control of an insurance company.[6] Among other things, the revised guidance provides that:

- regulators should request and review, as part of the Form A process, the investment, management or operational agreements of the persons proposing to acquire control of the insurance company for purposes of verifying control arrangements in "complex organization and ownership structures" of such proposed controlling persons. This guidance could result in state insurance regulators requesting organizational and other documents of affiliated entities in the control structure on a more systematic basis (which some states, but not all, already do as a matter of course);[7]
- regulators should review and assess the ability of the proposed ultimate controlling person of the insurance company ("UCP") to provide future capital support to the insurance company if needed;
- for non-U.S. acquiring parties, regulators should identify and investigate the nature and extent of government control of such acquiring parties; request any results of the Committee on Foreign Investment in the U.S. (CFIUS) review of the acquisition; and communicate and coordinate review of the Form A application with the acquirer's non-U.S. group-wide supervisor;
- in reviewing an acquisition involving Form A applications submitted to multiple states, the insurance group's lead state should coordinate with the other states in: (i) determining the proposed UCP of the insurance group; (ii) determining the persons, if any, for whom disclaimers of control should be approved; and (iii) determining the conditions and stipulations to be imposed in connection with disclaimer of control approvals;
- in reviewing disclaimers of control, regulators should consider the following as potentially indicating that "deeper review" of the disclaimer of control is required to determine whether control exists (and the disclaimer should therefore be disapproved) or whether any conditions or stipulations should be placed on the approval of the disclaimer of control:
    - in case of a proposed minority owner of an insurance company, whether such minority owner would have the ability to direct or influence management decisions or operations of that insurance company;
    - lending arrangements that may result in ownership of the insurance company in the event of default;

  - protective rights pursuant to which non-voting shareholders would have the ability to acquire control of the insurance company in any circumstances;

  - non-voting arrangements or contracts that "may convey an element of control", such as investment management agreements ("IMAs"), reinsurance agreements, administrative services agreements or employment agreements; or

  - in case of "passive" investment companies owning of 10% or more of voting shares within funds they manage, circumstances where the "actions and activities [of the investment company] do not support the investment company's assertion that it does not exert control" and go "beyond passively monitoring their investment". The adopted guidance clarifies that actions asset managers take in the ordinary course of their advisory services, such as engagement with management and proxy voting, should not be viewed as "actions and activities" potentially indicating control, and also expressly states that the purchase of equity or debt securities by passive investors—such as institutional investors, regulated funds and fund advisors—does not typically result in control of the insurance company.

  The adopted guidance states that, where the factual circumstances described above exist, the burden of proof is on the person applying for a disclaimer of control to demonstrate that it would not control the insurance company;

- regulators should consider whether the following stipulations or conditions should be imposed in connection with approvals of disclaimers of control:

  - in situations where ownership percentages may fluctuate, requiring the applicant to apply for a new disclaimer if its ownership percentage later exceeds a specified threshold; or

  - requesting that agreements proposed to be entered into between the insurance company and the applicant be submitted for the regulator's review notwithstanding the approval of the disclaimer; and

- with regard to IMAs with insurance companies, regulators should consider whether such agreements contain "non-customary terms that extend beyond advisory services and into broader influence over the insurer's business", such as "onerous and implausible in practice" termination provisions; authority over the insurance company's strategy, and implementation of such strategy, for managing its assets; or an affiliated investment adviser "becoming intertwined" in the insurance company's business operations.

Capital Maintenance Agreements; Parental Guarantees. Also between the Summer and Fall National Meetings, FASTWG adopted revisions to the NAIC Financial Analysis Handbook providing guidance to

regulators reviewing capital maintenance agreements ("CMAs") and parental guarantees between insurance companies and their affiliates.[8] The guidance does not include any requirement that parental guarantees or CMAs be requested in any particular scenarios; rather, it emphasizes the potential use of parental guarantees and CMAs as regulatory tools, for example in the following circumstances:

- "if deemed necessary" in connection with an application to acquire control of an insurance company (*i.e.*, a Form A application). The guidance does not indicate in which circumstances a parental guarantee or CMA should be "deemed necessary";
- when an insurance company is in hazardous financial condition or when its RBC ratio has fallen under one of the statutory action levels;[9]
- in connection with an application by an insurance company for a license to transact an insurance business in the state; or
- when there are "material concerns identified with other affiliated agreements within the group". The guidance does not provide any examples of "material concerns" that could trigger such requests.

The guidance also suggests that, in reviewing CMAs and parental guarantees, state insurance regulators should evaluate the financial stability of the guarantor to assess whether it is sufficiently capitalized to provide "adequate support" to the insurer or maintain its capital.

Surplus Notes. FASTWG's revisions to the NAIC Financial Analysis Handbook also include guidance to regulators pertaining to the proposed issuance of surplus notes by insurance companies.[10] The guidance suggests a number of specific areas of focus, and includes suggested contractual provisions. In particular, the guidance states or cautions that:

- Non-affiliated purchasers of the notes (such as third-party banks) may demand higher interest rates than purchasers affiliated with the insurance company, and the presence of third-party holders may also "make it more difficult" for the regulator to disapprove payments on the notes, as failure to make payments to third parties could impact the insurance company's credit ratings.
- Floating interest rates are "not appropriate" for surplus notes.
- If the surplus note is issued to the insurance company's parent, the regulator should request information about the source of funds, and consider it a "red flag" if the parent is borrowing money from a bank to loan to the insurance company, since that may indicate that the parent would be dependent on insurance company cash flows to service the bank note.
- Surplus notes should not be secured by pledges of the insurance company's stock as such a provision "would involve a change in control and require a Form A filing".[11]

Asset Adequacy Analysis for Certain Life and Annuity Reinsurance Transactions. LATF exposed for public comment an updated draft of an actuarial guideline (the "Reinsurance AAT Guideline")[12] that would require life insurance companies to use a cash flow testing methodology in performing asset adequacy analysis for the "Total Reserve" (*i.e.*, reserves held both by the cedent and the reinsurer, but excluding reserves held by the reinsurer that are not backed by certain types of "hard" assets) backing the following in-scope reinsurance agreements involving cessions of life insurance and annuity business:

- "Asset intensive reinsurance transactions" (defined as "coinsurance arrangements involving life insurance products[13] that transfer significant, inherent investment risk including credit quality, reinvestment, or disintermediation risk"[14]) entered into after certain specified dates (to be finalized, but anticipated to precede the issuance of the Reinsurance AAT Guideline by a number of years)[15] with reinsurers that are not required to submit a VM-30 memorandum[16] to U.S. state insurance regulators (i.e., non-U.S. reinsurers), and that meet any of the following criteria with respect to reserves backing the reinsurance arrangements:
  - More than $5 billion of reserve credit, funds withheld or modified coinsurance ("Modco") reserve; or
  - Combined reserve credit, funds withheld and Modco reserve greater than: (i) $1 billion, and 2% of the cedent's gross life insurance and annuity reserves; (ii) $100 million and 10% of such reserves; or (iii) $10 million and 20% of such reserves; or
- "Asset intensive reinsurance transactions" that result in "significant reinsurance collectability risk" (which is not quantified or otherwise defined). For year-end 2025, whether "significant reinsurance collectability risk" exists will be in the judgment of the ceding insurer's appointed actuary. LATF is considering whether the Reinsurance AAT Guideline should include objective standards for determining "significant reinsurance collectability risk" starting as of year-end 2026.

LATF plans to adopt the Reinsurance AAT Guideline in 2025 with an effective date of December 31, 2025 with respect to required disclosures of cash flow testing results and asset adequacy considerations. At initial effectiveness, the Reinsurance AAT Guideline will not include any requirements that additional reserves be posted if the testing fails, but LATF may reevaluate this approach and require the posting of additional reserves in certain circumstances if disclosures in 2025 raise concerns.

LATF anticipates that the Reinsurance AAT Guideline's requirements would initially apply to a population of approximately 100 reinsurance agreements.

KEY TAKEAWAYS

While on their face applicable to insurance companies regardless of ownership, the key substantive items advanced during the last few NAIC meetings (including changes to RBC treatment for structured securities, authority granted to the IAO to challenge ratings obtained via the FE process, enhanced asset adequacy testing for offshore reinsurance arrangements) are likely to have a greater impact on insurance companies owned by, or parties to reinsurance or investment management agreements with, private equity firms, particularly to the extent their investment portfolios include significant concentrations of structured securities or to the extent they currently benefit from reduced reserve requirements resulting from the cession of business to offshore reinsurers. In addition, the guidance regarding Form A applications and disclaimers of control, surplus note issuances, CMAs and parental guarantees, while non-binding, could prompt regulators to consider imposing these additional requirements on a more frequent or consistent basis.

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ENDNOTES

[1] *See* Sullivan & Cromwell LLP, "NAIC Private Equity Initiative – Summer 2024 Update" (Aug. 22, 2024), *available at* https://www.sullcrom.com/SullivanCromwell/_Assets/PDFs/Memos/NAIC-Private-Equity-Initiative-Summer-2024-Update.pdf.

[2] The latest update to this list of 13 regulatory considerations, dated August 19, 2024, is *available at* https://content.naic.org/sites/default/files/inline-files/13%20MWG%20Considerations%20-%20Status%208-19-24.pdf.

[3] The latest version of the framework, dated as of October 2024, is *available at* https://content.naic.org/sites/default/files/inline-files/Oct%202024%20Investment%20Framework.pdf.

[4] *See* NAIC Executive (EX) Committee and Plenary, "Revised Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office Authorizing the Procedures for the SVO's Discretion over NAIC Designations Assigned through the Filing Exemption Process" (Jul. 30, 2024), *available at* https://content.naic.org/sites/default/files/national_meeting/EX-Plenary_MATERIALS_FNM2024_1.pdf, Attachment Seven.

[5] *See* NAIC Financial Condition (E) Committee, "Request for Proposal – Credit Rating Provider Due Diligence Framework (Oct. 24, 2024), *available at* https://content.naic.org/sites/default/files/call_materials/E%20Committee%20Materials_0.pdf, Attachment D.

[6] *See* NAIC Financial Analysis Solvency Tools (E) Working Group, Form A and Disclaimer of Control/Affiliation, Revised Handbook Guidance" (Aug. 30, 2024), *available at* https://content.naic.org/sites/default/files/call_materials/Agenda%20and%20Materials_10.pdf, Attachment 9.

[7] *See* 11 NYCRR 80-1.6, Item 9(b) (providing that applications to acquire control of a New York domestic insurance company include as exhibits "[c]opies of any operating agreement, management agreement, partnership or limited partnership agreement, or any other contract or agreement" pursuant to which the proposed acquirers of such insurance company purport to control that insurance company).

[8] *See* NAIC Financial Analysis Solvency Tools (E) Working Group, "Financial Analysis Handbook Guidance for Parental Guarantees and/or Capital Maintenance Agreements" (Nov. 7, 2024), *available at* https://content.naic.org/sites/default/files/call_materials/Agenda%20and%20Materials%20%281%29.pdf, Attachment 5.

[9] The insurance laws governing RBC requirements for insurance companies adopted in each state provide that the state's domiciliary insurance regulator is required or permitted, as applicable, to take certain actions against a domestic insurance company if the insurance company's RBC ratio falls under certain statutory action levels—*i.e.*, the Company Action Level, the Regulatory Action Level, the Authorized Control Level and the Mandatory Control Level.

[10] A near-final version of this guidance is *available at* https://content.naic.org/sites/default/files/call_materials/Agenda%20and%20Materials%20%281%29.pdf, Attachment 3. Note that FASTWG made several further revisions to this guidance prior to adopting it, including, most materially: (i) inserting language requiring that the insurance company issue the surplus notes within 30 days (for surplus notes issued to affiliates) or 90 days (for surplus notes issued to non-affiliates) after receiving approval for the surplus notes from its domiciliary insurance regulator; and (ii) clarifying that insurance companies are not precluded from using the proceeds of a new surplus note to pay off an existing surplus note that is maturing.

[11] In our experience, at least some state insurance regulators would not treat a pledge of insurance company stock (but, instead, only the foreclosure of such pledge) to be a transaction constituting a change of control of that insurance company and requiring the filing of a Form A.

ENDNOTES (CONTINUED)

12 *See* NAIC Life Actuarial (A) Task Force, "AG ReAAT – Draft 11/15/24" (Nov. 15, 2024), *available at* https://content.naic.org/sites/default/files/inline-files/Draft%20AG%20ReAAT_111524_.pdf.

13 The definition of "asset intensive reinsurance transactions" included in the current draft of the Reinsurance AAT Guideline does not expressly include coinsurance arrangements involving annuity products, which seems contrary to the intent of the drafters.

14 As defined in Appendix A-791 to the NAIC Accounting Practices and Procedures Manual, "Life and Health Reinsurance Agreements", as follows:

- Credit quality risk: the risk that invested assets supporting the reinsured business will decrease in value, including primarily risks that assets will default or that there will be a decrease in earning power. Credit quality risk excludes market value declines due to changes in interest rates.
- Reinvestment risk: the risk that interest rates will fall and funds reinvested will therefore earn less than expected. In circumstances where asset durations are less than liability durations, this mismatch will increase.
- Disintermediation risk: the risk that interest rates rise and policy loans and surrenders increase or maturing contracts do not renew at anticipated rates of renewal. In circumstances where asset durations are greater than liability durations, this mismatch will increase.

15 These dates are still subject to further discussion by LATF, and may be different for affiliated and non-affiliated reinsurance agreements. The current draft of the Reinsurance AAT Guideline proposes that its requirements be applied to reinsurance agreements established on or after January 1, 2016, and that LATF may consider implementing a January 1, 2020 effective date for non-affiliated reinsurance agreements.

16 The NAIC Valuation Manual provides that (re)insurance companies that are required to file Life, Accident and Health or Fraternal statutory annual statements with U.S. state insurance regulators are also required to file, on an annual basis, VM-30 actuarial opinions and memoranda on the adequacy of the insurance company's reserves based on an asset adequacy analysis. Non-U.S. reinsurers are not required to file statutory financial statements with the NAIC or U.S. state insurance regulators, and are therefore exempt from the requirement to file VM-30 actuarial opinions and memoranda.

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