

August 22, 2024

NAIC Private Equity Initiative – Summer 2024 Update

Update on the NAIC Initiative Applicable (but Not Exclusive) to Private Equity Ownership of Insurers and Insurer Investment Practices, on Its Second Anniversary

SUMMARY

This memorandum discusses key developments from the August 12 to 15, 2024 Summer National Meeting (the “Summer National Meeting”) of the National Association of Insurance Commissioners (“NAIC”) in respect of its “private equity initiative,” which marked its second anniversary.

BACKGROUND

Since our last update on the NAIC’s “private equity initiative,”¹ various NAIC committees and sub-groups have continued their work, developing or adopting:

- a long-term framework for the regulation of insurer investments, largely unchanged from prior iterations;
 - initiatives related to insurance company investments in structured securities, including confirming previously adopted RBC factors for residual tranches of structured securities held by insurance companies, set at 45% for life insurance companies and 20% for property and casualty and health insurance companies;
 - enhanced regulatory oversight of ratings obtained from rating agencies, which would give the NAIC’s Investment Analysis Office (“IAO”) the ability, in circumstances that are expected to be infrequent, to set aside ratings obtained from rating agencies in the process of assigning NAIC designations; and
 - previously exposed guidance for the review by regulators of investment management agreements between insurance companies and their affiliates.
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In addition, the NAIC Macroprudential (E) Working Group (“MWG”) released a document tracking the NAIC’s progress on the initiative against the NAIC’s list of 13 regulatory considerations (the “NAIC List”).²

UPDATE ON NAIC INITIATIVES RELATED TO THE NAIC LIST

NAIC Framework for Regulation of Insurer Investments. The NAIC Financial Condition (E) Committee (the “(E) Committee”) exposed for public comment an updated draft of its proposed framework for regulation of insurer investments (the “Draft Framework”) and related work plan,³ with relatively minor changes from their previous iterations. Significantly, the Draft Framework has been revised to expressly state that the following principles are expected to continue to guide efforts on the Draft Framework even as detailed plans evolve:

1. The goal of the Draft Framework is to set a long-term, strategic direction for investment regulation, with thoughtful coordination among current and future NAIC initiatives.
2. Its primary objective is to provide state insurance regulators with the requisite tools to ensure solvency of insurers.
3. Ongoing parallel work streams related to insurance company investments will continue, as they are “directionally consistent with the [Draft Framework] and produce iterative feedback to inform future progress toward its objectives.”
4. Related initiatives will continue to be regulator-driven, and regulators will retain authority over any centralized NAIC resources developed in the process.
5. The work plan will be fully transparent and involve significant deliberations with interested parties.
6. Ultimate responsibility for prudent oversight of investments “is with the insurers themselves,” not rating agencies or regulators.

The (E) Committee also exposed for public comment a draft request for proposal (“RFP”) for a consultant to design and help implement a due diligence framework for rating agencies used by the NAIC as credit rating providers (“CRPs”), which could include quantitative and qualitative standards for CRPs.⁴

RBC Requirements for Structured Securities. The NAIC Risk-Based Capital Investment Risk and Evaluation (E) Working Group (“RBCIREWG”) confirmed its earlier determination that the risk-based capital (“RBC”) factor for residual tranches of structured securities held by life insurance companies should be set at 45% for year-end 2024 and subsequent years. That factor was initially set at 30% for year-end 2023 and due to increase to 45% for year-end 2024 absent new information that would have warranted a change. The 45% factor is subject to change in the future to the extent warranted based on the RBCIREWG’s development of comprehensive RBC frameworks applicable to all tranches of collateralized loan obligations (“CLOs”) and other structured securities.⁵

Separately, following a review of the adequacy of the 20% factor currently applicable in respect of residual tranches of structured securities held by property and casualty and health insurance companies, the NAIC Capital Adequacy (E) Task Force determined that the 20% factor should remain unchanged.⁶

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In addition, the American Academy of Actuaries reported to the RBCIREWG that it expects to complete its work on the development of a comprehensive framework for obtaining RBC factors for all tranches of CLOs in early 2025.

VOSTF – Proposal to Add IAO Discretion to Remove Securities from Filing Exempt Process. The Valuation of Securities (E) Task Force (“VOSTF”) adopted an amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”) which would allow the IAO to exclude certain rating agency credit ratings, or remove securities, from the filing exempt (“FE”) process if the IAO, following a self-initiated or a regulator-initiated review, determines that the resulting NAIC Designation does not provide a reasonable assessment of applicable risk for regulatory purposes.⁷ The amendment reflects certain changes from the draft exposed in June 2024, including an express statement that this process “will be consistently applied to all CRPs, without favor to any individual CRP or class of CRPs,” and “is not expected to be used often.” The (E) Committee will consider adopting this proposal later this month; if adopted, the IAO discretionary authority will become effective as of January 1, 2026, unless a delay is needed to implement the requisite technological enhancements.

Affiliated Investment Management Agreements. The guidance for review of affiliated investment management agreements by state insurance regulators⁸ was adopted substantially in the form exposed in March 2024 by the NAIC Risk-Focused Surveillance (E) Working Group (“RFSWG”). This guidance includes various standards pertaining to the level of authority provided to the investment advisor, fees, termination provisions, appointment of sub-advisers, conflicts of interest, and various other matters with which a state insurance regulator could require an affiliated investment management agreement to comply in order for such agreement to be considered fair and reasonable.⁹ The guidance will be included in the 2025 editions of the NAIC Financial Analysis Handbook and the NAIC Financial Condition Examiners Handbook.

Capital Maintenance Agreements; Surplus Notes. The NAIC Financial Analysis Solvency Tools (E) Working Group (“FASTWG”) formed a drafting group tasked with reviewing the considerations in the NAIC List related to surplus notes and capital maintenance agreements, and developing guidance as needed.¹⁰

Asset Adequacy Analysis for Certain Life and Annuity Reinsurance Transactions. The Life Actuarial (A) Task Force (“LATF”) exposed for public comment a “strawman” initial draft of an actuarial guideline (the “Reinsurance AAT Guideline”)¹¹ that would require life insurance companies to use a cash flow testing methodology in performing their asset adequacy analysis with respect to ceded life insurance and annuity business.

Under the Reinsurance AAT Guideline, the life insurance company’s appointed actuary would be required to perform more frequent and/or rigorous analyses of significant risks identified with respect to ceded

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reinsurance, which could be evidenced by: (i) the reinsurer not providing a U.S. regulator with the opinion and memorandum of its appointed actuary regarding reserve adequacy required by VM-30; (ii) a significant reserve decrease due to the use of assets other than certain “stable” assets (referred to as “primary security”)¹² to support reserves; (iii) significant collectability risk associated with the reinsurer; or (iv) potentially other factors, such as the reinsurer’s affiliation with the cedent. In circumstances where high risk has been identified, the Reinsurance AAT Guideline would require the appointed actuary to perform cash flow testing of the “Total Reserve” with respect to the ceded liabilities (*i.e.*, the reserves held by the cedent, plus reserves held by the reinsurer, other than those supported with assets constituting “primary security”). In addition, regulators are considering whether the requirement to perform cash flow testing should be eliminated when protections such as trusts or funds withheld are in place.

The draft Reinsurance AAT Guideline also includes parameters that could be used to perform attribution analysis for individual treaties (*i.e.*, an analysis of the reserve decrease between (i) the U.S. statutory reserve held by the cedent with respect to the ceded liabilities prior to the reinsurance transaction and (ii) the post-reinsurance “Total Reserve” held against such liabilities, with a step-by-step estimate of the proportion of such decrease attributable to each factor contributing to the decrease—such as adjustments due to differences in key assumptions (*e.g.*, those regarding policyholder behavior, mortality or longevity, investment returns and/or taxes) or due to other factors, such as the removal of the cash surrender value floor, market value or book value difference due to changes in interest rates, moderately adverse to less adverse or best estimate conversion—but does not indicate whether an attribution analysis would serve as an alternative to cash flow testing (*i.e.*, to be performed in lieu of cash flow testing in cases where the risk is judged to be moderate, not high) or will instead function as a supplement to any other analysis being performed. Regulators expect that the Reinsurance AAT Guideline will undergo “many” iterations and public exposures before effectiveness, which is targeted for year-end 2025.

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ENDNOTES

- 1 See Sullivan & Cromwell LLP, “NAIC Private Equity Initiative – Spring 2024 Update” (Apr. 8, 2024), *available at* <https://www.sullcrom.com/SullivanCromwell/Assets/PDFs/Memos/NAIC-Private-Equity-Initiative-Spring-2024-Update.pdf>.
- 2 See NAIC Macroprudential (E) Working Group, “Tracking for the List of 13 MWG Considerations – PE Related and Other” (Aug. 19, 2024), *available at* <https://content.naic.org/sites/default/files/inline-files/13%20MWG%20Considerations%20-%20Status%208-19-24.pdf>.
- 3 See NAIC Financial Condition (E) Committee, “Response to Written Comments on Holistic Framework on Insurers Investments & Workplan” (Aug. 2, 2024), *available at* https://content.naic.org/sites/default/files/national_meeting/ecmte-materials-20240815_1.pdf, Attachment Thirteen.
- 4 See NAIC Financial Condition (E) Committee, “Request for Comments on the Draft Request for Proposal” (Aug. 2, 2024), *available at* https://content.naic.org/sites/default/files/national_meeting/ecmte-materials-20240815_1.pdf, Attachment Twelve.
- 5 See NAIC Risk-Based Capital Investment Risk and Evaluation (E) Working Group, “Meeting Summary Report for the Capital Adequacy (E) Task Force” (June 28, 2024), *available at* https://content.naic.org/sites/default/files/call_materials/CapAd_Materials_062824.pdf, Attachment G.
- 6 See NAIC Capital Adequacy (E) Task Force, Proposal 2024-28-CA (Residual Factor for PC & Health) (June 2024), *available at* https://content.naic.org/sites/default/files/call_materials/CapAd_Materials_062824.pdf, Attachment H.
- 7 See Valuation of Securities (E) Task Force, “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” (July 30, 2024), *available at* <https://content.naic.org/sites/default/files/inline-files/2023-005.16a%20PP%20SVO%20Discretion%20-%20Revised%20v6.2.pdf>.
- 8 See NAIC Risk-Focused Surveillance (E) Working Group, Proposed NAIC Handbook Guidance for Review of Affiliated Investment Management Agreements and Services (May 2024), *available at* https://content.naic.org/sites/default/files/call_materials/RFSWG-5-30-24-MaterialsCombined.pdf, Attachment B.
- 9 These standards are described in more detail in our Spring 2024 update on the NAIC private equity initiative. See Sullivan & Cromwell LLP, “NAIC Private Equity Initiative – Spring 2024 Update” (Apr. 8, 2024), *available at* <https://www.sullcrom.com/SullivanCromwell/Assets/PDFs/Memos/NAIC-Private-Equity-Initiative-Spring-2024-Update.pdf>.
- 10 Early iterations of the NAIC List stated that regulators have discussed “[s]urplus notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate” and “[c]apital maintenance agreements, suggesting guidance for the appropriate entities to provide them and considering ways to make them stronger,” and FASTWG’s work will therefore presumably focus on some or all of these issues.
- 11 See NAIC Life Actuarial (A) Task Force, “AAT for Reinsurance Actuarial Guideline” (Aug. 11, 2024), *available at* https://content.naic.org/sites/default/files/national_meeting/Materials_SummerNatiMtg_LATF_2024_v2.pdf, Agenda Item 10.
- 12 The definition of “primary security” has not yet been finalized, but one suggestion being considered by LATF is to use the definition of “primary security” from Actuarial Guideline XLVIII, “Actuarial Opinion and Memorandum Requirements for the Reinsurance of Policies Required to Be Valued under Sections 6 and 7 of the NAIC Valuation of Life Insurance Policies Model Regulation (Model 830).” Under this definition, “primary security” consists of: (i) cash meeting the

ENDNOTES (CONTINUED)

requirements of Section 3(A) of the NAIC Credit for Reinsurance Model Law; (ii) SVO-listed securities meeting the requirements of Section 3(B) of the NAIC Credit for Reinsurance Model Law (*i.e.*, those qualifying as admitted assets), but excluding any synthetic letter of credit, contingent note, credit-linked note or other similar security that operates in a manner similar to a letter of credit; and (iii) for securities held in connection with funds withheld and modified coinsurance reinsurance arrangements, commercial loans in good standing and rated CM3 or higher; policy loans; and derivatives acquired in the normal course and used to support and hedge liabilities pertaining to the actual risks in the policies ceded pursuant to the reinsurance arrangement.

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