

January 6, 2023

## Update on NAIC's Private Equity Initiative

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### Latest Developments in NAIC Initiative Applicable (but Not Exclusive) to Private Equity Ownership of Insurers and Insurer Investment Practices

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#### SUMMARY

At the NAIC Fall 2022 National Meeting, which took place on December 12–16, 2022 (the “Fall National Meeting”), state insurance regulators continued their work to address the 13 regulatory considerations set forth in the list (the “NAIC List”) adopted by the National Association of Insurance Commissioners (the “NAIC”) in August 2022 pertaining to concerns related to the increasing number of U.S. insurance companies owned by private equity firms.<sup>1</sup> The regulatory considerations set forth in the NAIC List are “not exclusive” to private equity-owned insurers, and, accordingly, many of the NAIC initiatives to address these regulatory considerations apply broadly to any insurance company engaged in the specified activities. This memorandum provides an update on these NAIC initiatives.

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#### BACKGROUND

Certain NAIC projects addressing the regulatory considerations set forth in the NAIC List have already been completed. For example, the NAIC has adopted Actuarial Guideline LII, *Application of the Valuation Manual for Testing the Adequacy of Life Insurer Reserves* (the “AAT Guideline”) which specifies additional asset adequacy analysis requirements for life insurers, including specifically with respect to certain “complex assets.”<sup>2</sup> The NAIC has also adopted statutory accounting guidance that requires additional disclosures pertaining to investment transactions between an insurance company and its “related parties.” However, many other NAIC initiatives related to the regulatory considerations set forth in the NAIC List remain ongoing. In advance of its session at the Fall National Meeting, the NAIC Macroprudential (E) Working Group (the “MWG”)—which leads NAIC efforts related to the NAIC List—published an update on the status of these initiatives (the “NAIC List Update”).<sup>3</sup> In addition, over the last few months—including at the Fall National Meeting—several NAIC committees have undertaken

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significant work that has led, or will likely lead, to changes to risk-based capital (“RBC”) treatment and/or filing exempt status of certain structured securities and “related party” investments.

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### UPDATE ON NAIC INITIATIVES RELATED TO THE NAIC LIST

**New Filing Exemption Guidance for “Related Party” Investments.** In August 2022, the NAIC adopted revisions to *SSAP No. 25 – Affiliates and Other Related Parties* and *SSAP No. 43R – Loan-Backed and Structured Securities* that require additional statutory financial statement disclosures of investment transactions between an insurance company and “related parties”—a term that is intentionally broader than the term “affiliate” as it is used in the NAIC *Insurance Holding Company System Regulatory Act* (transactions between an insurance company and its affiliates were already subject to disclosure in the insurance company’s financial statements prior to the adoption of this guidance).<sup>4</sup> Among other things, these amendments provide that a loan-backed or structured security is subject to reporting as a related party investment if: (i) the security has underlying collateral held in trust that “predominantly reflects” assets issued by affiliates or related parties of the insurance company, even if the security was acquired from a non-related party issuer; or (ii) a related party or affiliate was involved in sponsoring or originating the security or any type of underlying servicing arrangement.

Following the adoption of this guidance, the Statutory Accounting Principles (E) Working Group (“SAPWG”) sent a referral to the Valuation of Securities (E) Task Force (“VOSTF”), requesting that the NAIC Securities Valuation Office (“SVO”) consider whether to revise the NAIC’s filing exempt, or “FE,” process<sup>5</sup> in respect of related party investments. In response, VOSTF adopted during its session at the Fall National Meeting the following revisions to the P&P Manual:<sup>6</sup>

- Bond and preferred stock investment transactions between an insurance company and an entity that is a subsidiary or controlled by or affiliated with the insurance company (“SCA”) or a related party are not eligible for the FE process if the bond or preferred stock has direct or indirect credit risk exposure to the SCA or related party, whether as issuer or otherwise. Consequently, such investment transactions must be filed with the SVO for purposes of receiving an NAIC Designation.
- Conversely, a bond or preferred stock investment transaction that has no direct or indirect credit risk exposure to the SCA or related party qualifies for FE (unless otherwise disqualified for other reasons). For example, the following could qualify for FE: (i) an investment issued by an SCA or related party special purpose entity that itself is not an obligor or party to which the insurance company has direct or indirect credit risk exposure, and (ii) an investment issued as part of a structure in which the originator, sponsor, manager, servicer or “other influential transaction party”<sup>7</sup> is an affiliate or related party of the insurance company, but that does not have direct or indirect credit risk exposure to SCAs or related parties of the insurance company. The adopted revisions to the P&P Manual further clarify that an insurance regulator would not be prohibited from requiring an insurance company to file such an investment with the SVO for analysis and/or assignment of an NAIC Designation.

**Privately Structured Securities.** MWG has previously expressed support for the SVO’s proposal that insurance companies be required to add various data to statutory financial statements concerning

securities in which they invest, including market yields for such securities. If implemented, this proposal could enable state insurance regulators and/or the SVO to analyze a particular security's NAIC Designation and market yield with the goal of determining whether the market yield might indicate that there are risks inherent in the security that are not captured in determining the NAIC Designation. This proposal has been subject to significant pushback from the industry—including because certain industry members anticipate that the associated costs to insurance companies could be significant, and because industry members desire to understand how this data would be utilized. As an alternative to having the insurance companies provide this data, certain interested parties have suggested that the SVO could aggregate this data from commercially available sources or, for private securities, from private rating rationale reports required to be filed with the SVO.

In an apparent move toward the industry's position, the NAIC List Update states that VOSTF will be sending referrals to other NAIC committees requesting feedback on an alternative proposal whereby the NAIC would produce analytical risk metrics for bond investments.

**Collateralized Loan Obligations.** The Risk-Based Capital Investment Risk and Evaluation (E) Working Group ("RBCIREWG") is continuing its work on a comprehensive long-term project to determine RBC charges for all tranches of collateralized loan obligations ("CLOs"), as well as an interim solution to develop the appropriate RBC charge for residual tranches<sup>8</sup> of CLOs—which would be in effect until the comprehensive CLO RBC framework is finalized and adopted. The RBCIREWG has asked the American Academy of Actuaries (the "AAA") to assist with this work. AAA representatives reported, based on preliminary work, that bond RBC factors may not be appropriate for CLOs. AAA representatives also noted that exposure to CLOs across the life insurance industry and in most individual life insurance companies currently appears to be relatively small, and should not be a major concern for their surplus or solvency—affording the RBCIREWG time to undertake the work required to determine the correct RBC factors for all CLO tranches.

Separately, VOSTF has been continuing its work on a project that is expected to result in CLOs becoming ineligible for FE status. Under VOSTF's proposed amendment to the P&P Manual,<sup>9</sup> CLOs would instead become subject to a financial modeling process by the SVO, which would function similarly to the financial modeling process that is currently applicable to insurance company investments in RMBS and CMBS. Pursuant to this existing process, insurance companies that invest in RMBS or CMBS are required to obtain from the SVO certain data that constitutes the results of financial modeling performed by the SVO or its vendor and that can be used by the insurance company to derive an NAIC Designation for a particular RMBS or CMBS in which it has invested. If adopted this year as anticipated, it is expected that this amendment to the P&P Manual will become effective as of January 1, 2024.

As part of the same initiative, VOSTF exposed for comment the SVO's proposed methodology for modeling CLOs.<sup>10</sup> Under the proposed methodology, the SVO expects to model all tranches of broadly

syndicated loan CLOs held by U.S. insurance companies, except the following: (i) commercial real estate CLOs, since different assumptions are required where the underlying risk is commercial real estate, (ii) re-securitizations, asset-backed securities, CDOs and trust preferred securities CDOs, and (iii) middle market CLOs on a temporary basis, until appropriate assumptions are developed, which the SVO hopes will occur “shortly.” The proposed methodology does not yet include any modeling scenarios, the discussion of which is expected to be more controversial.

**Reliance on Rating Agencies.** An *ad hoc* group composed of certain NAIC staff members, insurance regulators and industry representatives was previously formed to study whether the U.S. insurance regulatory framework’s current reliance on rating agency ratings to produce NAIC Designations for securities in which insurance companies invest is appropriate for regulatory purposes or, as an alternative, whether the SVO should instead be charged with producing NAIC Designations for such securities. VOSTF Chair, Carrie Mears (Iowa Division of Insurance), indicated at the Fall National Meeting that this *ad hoc* group is no longer meeting, and that regulator-to-regulator discussions will now take place to determine any appropriate next steps related to this work stream.

**Use of Offshore Reinsurers, Captives and Sidecars.** One of the regulatory considerations included in the NAIC List relates to U.S. insurers’ use of offshore reinsurers, including captives and complex affiliated sidecar vehicles—which the NAIC List states may “maximize capital efficiency, reduce reserves, increase investment risk, and introduce complexities into the group structure.” MWG has been engaging in confidential discussions with industry members and certain non-U.S. jurisdictions to identify the best mechanism to ensure that a state insurance regulator reviewing a reinsurance transaction involving an offshore reinsurer would be able to identify its true economic impact. MWG will then consider which further actions should be undertaken in order to address this regulatory consideration.

**Pension Risk Transfers.** The key remaining NAIC work stream relating to pension risk transfer (“PRT”) considerations set forth in the NAIC List involves work by the Longevity Risk (E/A) Subgroup and its sub-committees to potentially develop PRT and longevity risk mortality RBC factors. In addition, the NAIC List Update notes that NAIC staff are continuing to hold discussions with U.S. Department of Labor representatives regarding the “U.S. Department of Labor protections” as related to a PRT transaction.

The NAIC List Update also notes that no further work is necessary to address the comparison of protections available under state insurance guaranty funds vs. the Pension Benefit Guaranty Corporation.

**“Control” by Owners of Less than 10% of Voting Securities; Complex Holding Company Structures and Contractual Arrangements.** The Group Solvency Issues (E) Working Group (the “Group Solvency Working Group”) has been charged with addressing the regulatory considerations in the NAIC list relating to: (i) persons that may control an insurance company despite owning, directly or indirectly, less than 10% of the issued and outstanding voting securities of that insurance company, and (ii) holding

company structures and affiliated contractual arrangements that may be structured “to avoid regulatory disclosures and requirements.” During initial discussions, the Group Solvency Working Group indicated that possible next steps may include developing training materials for state insurance regulators on these complex structures and arrangements and developing a list of factual circumstances in which a person that owns, directly or indirectly, less than 10% of the issued and outstanding voting securities of an insurance company would nonetheless be considered to control that insurance company under state insurance laws.

**Asset Manager Affiliates and Disclaimers of Affiliation.** The NAIC List Update states that the MWG will wait for the results of other NAIC committees’ work on related matters before undertaking any further actions to address this work stream. This work includes the recently adopted revisions to Schedule Y, Part 3 that require additional disclosures concerning entities with greater than 10% ownership of insurance companies, including express disclosure of any such entity that has been granted a disclaimer of affiliation.

SAPWG also has several projects addressing this consideration, including the proposed additional revisions to *SSAP No. 25 – Affiliates and Other Related Parties* and statutory financial statement reporting requirements that clarify that an “affiliated investment” required to be reported on the “affiliated” line in the statutory financial statement investment schedules includes “any invested asset held by [an insurance company] which is issued by an affiliated entity, or which includes the obligations of an affiliated entity.”<sup>11</sup>

**Investment Management Agreement Provisions; Owners of Insurers with Short-Term Focus and/or Unwilling to Support a Troubled Insurer.** The Risk-Focused Surveillance (E) Working Group (“RFSWG”) has been charged with addressing the regulatory considerations in the NAIC List relating to: (i) investment management agreement provisions that may not be arm’s-length or that may result in conflicts of interest, and (ii) concerns about owners of insurers that may be focused on short-term results that may not be in alignment with the long-term nature of life product liabilities and/or that may not be willing to transfer capital to a troubled insurer. RFSWG has not yet begun its work to address these charges, and plans to do so starting in early 2023.

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## RELATED DEVELOPMENTS

**FIO’s Annual Report on the Insurance Industry Discusses Increased Focus on Private Equity in the Life Insurance Sector.** In September 2022, the Federal Insurance Office (“FIO”) issued its 2022 report on the U.S. insurance industry,<sup>12</sup> which, among other things, notes that U.S. insurers owned by private equity firms owned over \$1 trillion in cash and invested assets as of year-end 2021, representing a significant increase from the corresponding figure at year-end 2020 (\$471 billion). The report also notes that a substantial amount of assets is held by private equity-owned life reinsurers, which have

become a significant source of reinsurance for U.S.-domiciled ceding insurers. The report reiterates that FIO has identified four areas of priority for its continued analysis and engagement, including: (i) liquidity, as relates to transition from traditional asset classes, such as bonds, to higher-yielding, but less liquid, asset classes, such as real estate, CLOs and other privately structured securities, (ii) credit risk and capital adequacy relating to activities that link affiliated origination platforms, securitization strategies and asset allocation approaches, (iii) offshore reinsurance implications, including monitoring the growth of offshore reinsurance and assessing why this growth is occurring, and (iv) potential conflicts of interest arising from management and investment fee structures and sourcing from affiliated origination platforms. The report states that FIO will continue to monitor developments in this space and to consider implications for policyholders and the financial system.

**IAIS Continues Its Focus on Private Equity Ownership of Insurers.** The 2021 Global Insurance Market Report (“GIMAR”) released by the International Association of Insurance Supervisors (the “IAIS”) highlighted private equity ownership of insurance companies as a key sector-wide macroprudential theme, noting that certain supervisory authorities believe that private equity-owned insurers “may pose unique risks.” On December 15, 2022, the IAIS released its 2022 GIMAR,<sup>13</sup> which likewise identifies structural shifts in the insurance sector, including the involvement of private equity, as a key macroprudential theme. The 2022 GIMAR states that private equity-involved insurers have been identified as generating additional microprudential and/or macroprudential concerns in certain jurisdictions. For example, the 2022 GIMAR notes that there has been an upward trend in cross-border reinsurance of life insurance liabilities by both private equity-owned and other insurers—which is an activity that the IAIS believes should be better understood and monitored. The 2022 GIMAR also describes concerns relating to: (i) asset allocation of private equity-involved insurers, such as investments in assets that are less liquid, less transparent and more complex, (ii) “herding” – *i.e.*, attempts by other life insurers to emulate investment and cross-border reinsurance strategies employed by private equity-involved insurers without possessing “the same expertise or experience in the strategies employed,” (iii) transparency, including in particular with respect to private equity firms’ structures that may “exhibit complexity and opacity,” making the identification and monitoring of key risks more difficult, and (iv) potential conflicts of interest between private equity firms involved in insurance and insurers’ other stakeholders, such as supervisors, policyholders and long-term investors.

The 2022 GIMAR notes the key role of supervisory collaboration aimed at transparency and exchange of information in the supervision of private equity-involved insurance groups with cross-border reinsurance transactions. The 2022 GIMAR also includes five concrete examples of measures insurance supervisors might take, including: (i) capital add-ons or higher solvency ratios, which may be imposed to address risks inherent in the business model, including complex investment strategies, (ii) mandatory bespoke regulatory stress tests to facilitate supervisory understanding of risk mitigation across a range of severe stress scenarios; where necessary, the supervisor may require adequate liquidity facilities and legally

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enforceable capital maintenance agreements to support contingency capital plans; (iii) restrictions on dividend extraction and other ways to extract value from an insurer directly or indirectly, such as via fees; (iv) requiring insurers to establish and implement effective corporate governance frameworks and internal controls; and (v) requiring additional disclosures and transparency regarding the relevant risks.

The IAIS plans to broaden its evaluation of the impact of private equity-involved insurers to include further activities, such as investment allocations to less liquid investments, the use of cross-border reinsurance and potential for “herding” and higher concentration risks. The IAIS also plans to continue examining risks that may be more specific to private equity ownership of insurers, such as conflicts of interest and transparency relating to ownership and control. As part of these efforts, the IAIS expects to refine its annual Global Monitoring Exercise (GME) to enhance the monitoring of alternative investments and private placements and better capture transfers of life insurance portfolios, including via reinsurance.

Unlike the NAIC and FIO initiatives, which affect only (re)insurers with a U.S. presence, the IAIS’s efforts have potential worldwide implications, to the extent adopted by relevant jurisdictions.

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## ENDNOTES

- 1 Our previous publication describing this NAIC initiative in further detail, “NAIC Adopts List of Regulatory Considerations Applicable (But Not Exclusive) to Private Equity-Owned Insurers” (Aug. 19, 2022), is available at <https://www.sullcrom.com/files/upload/sc-publication-naic-adopts-considerations-related-to-private-equity-owned-insurers.pdf>.
- 2 The AAT Guideline states that examples of such “complex assets” include structured securities, asset-backed securities and CLOs, as well as assets originated by the insurance company or its affiliates or related entities. Because complex assets are “difficult to classify,” and given the AAT Guideline’s focus on “projected net yields and cash flows” from these assets, many—but not all—of the requirements set forth in the AAT Guideline apply only to assets “categorized as high-yielding”—i.e., “Projected High Net Yield Assets,” as defined in Section 3(F) of the AAT Guideline.
- 3 See NAIC Macroprudential (E) Working Group, Plan for the List of MWG Considerations – PE Related and Other (Dec. 13, 2022), available at <https://content.naic.org/sites/default/files/inline-files/13%20MWG%20Considerations%20-%20Status%2012-13-22.pdf>.
- 4 “Related parties” include, in addition to persons or entities traditionally considered to be “affiliates,” the principal owners, directors and officers of the insurance company; the management of the insurance company and its affiliates; and any party that is not considered an affiliate of the insurance company due to the insurance company’s domiciliary state insurance regulator having approved a disclaimer of affiliation with respect to the insurance company.
- 5 “FE” refers to the rule set forth in the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the “P&P Manual”) that certain securities, including certain bonds that have been assigned an eligible rating by an acceptable rating agency, need not be filed with the SVO for purposes of determining their NAIC Designation. See, e.g., P&P Manual, Part One – Policies of the NAIC Valuation of Securities (E) Task Force, § 82. Instead, the NAIC Designation for a security that qualifies for FE is determined by reference to the rating(s) assigned to such a security by the applicable rating agencies. See P&P Manual, Part Three – SVO Procedures and Methodology for Production of NAIC Designations, § 25. Securities that are not FE must be filed with the SVO, which then independently evaluates the security and determines its NAIC Designation.
- 6 See NAIC Valuation of Securities (E) Task Force, Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office Regarding Subsidiary, Controlled and Affiliated Debt or Preferred Stock Investments (Dec. 8, 2022), available at [https://content.naic.org/sites/default/files/inline-files/2022-008.04\\_VOSTF\\_Amend\\_SVO\\_RelatedParties\\_forTFreview.docx](https://content.naic.org/sites/default/files/inline-files/2022-008.04_VOSTF_Amend_SVO_RelatedParties_forTFreview.docx).
- 7 The term “other influential transaction party” is not defined in the new P&P Manual guidance.
- 8 In general, the term “residual tranche” of a CLO refers to the equity tranche of the CLO.
- 9 See NAIC Valuation of Securities (E) Task Force, Amendment to the Purposes and Procedures Manual of the NAIC Investment Analysis Office to Include Collateralized Loan Obligations (CLO) as a Financially Model Security in Part Four (Sep. 16, 2022), available at [https://content.naic.org/sites/default/files/national\\_meeting/VOSTF%20Materials%202022-12-14%20v8.pdf](https://content.naic.org/sites/default/files/national_meeting/VOSTF%20Materials%202022-12-14%20v8.pdf), Attachments Three and Three-A.
- 10 See NAIC Valuation of Securities (E) Task Force, Proposed Methodology for Modelling CLOs (Dec. 12, 2022), available at <https://content.naic.org/sites/default/files/inline-files/2022-017.01%20CLO%20Exposure%20Methodology%20Draft%20v5.docx>.
- 11 See Statutory Accounting Principles (E) Working Group, Maintenance Agenda Submission Form, Ref #2022-15 (Nov. 2022), available at [https://content.naic.org/sites/default/files/national\\_meeting/12-22%20SAPWG%20Meeting%20materials\\_0.pdf](https://content.naic.org/sites/default/files/national_meeting/12-22%20SAPWG%20Meeting%20materials_0.pdf), Attachment C.



ENDNOTES CONTINUED

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- <sup>12</sup> See Federal Insurance Office, Annual Report on the Insurance Industry (September 2022) (Sep. 2022), *available at* <https://home.treasury.gov/system/files/311/2022%20Federal%20Insurance%20Office%20Annual%20Report%20on%20the%20Insurance%20Industry%20%281%29.pdf>.
- <sup>13</sup> See IAIS, Global Insurance Market Report (Dec. 15, 2022), *available at* <https://www.iaisweb.org/uploads/2022/12/GIMAR-2022.pdf>.

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