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NAIC Adopts List of Regulatory Considerations Applicable (But Not Exclusive) to Private Equity-Owned Insurers

New, Multifaceted NAIC Initiative Devoted to Private Equity Ownership of Insurers and Insurer Investment Practices

SUMMARY

On August 13, 2022, the National Association of Insurance Commissioners ("NAIC") Executive (EX) Committee and Plenary adopted the *Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers* (the "NAIC List"),[1] which sets forth the NAIC's action plan for addressing a variety of concerns related to the increasing number of U.S. insurance companies that are owned by private equity firms. The NAIC's concerns generally relate to a perceived lack of transparency and additional risks inherent in the relationships between insurance companies and owners that are private equity firms or other affiliates or related parties, including with respect to related party investments, structured securities, and other complex assets in which insurance companies have increasingly been investing. The NAIC's efforts in addressing these concerns are led by the NAIC Macroprudential (E) Working Group ("MWG"), as well as by its parent committee, the Financial Stability (E) Task Force ("FSTF").

BACKGROUND

Considerations relating to acquisitions and ownership of U.S. insurance companies by private equity firms are not a new subject for the NAIC. Nearly a decade ago, in response to concerns raised by certain U.S. insurance regulators about the increasing pace of acquisitions of insurance companies by private equity firms, the NAIC formed the Private Equity Issues (E) Working Group ("PEIWG") for the purpose of developing regulatory guidance designed to monitor and mitigate potential risks stemming from such

acquisitions. The PEIWG's work took nearly two years and culminated in an update to the NAIC's *Financial Analysis Handbook*, which, among other things, lists certain commitments (*i.e.*, "stipulations") that a state insurance regulator could consider imposing on a private equity firm that has applied for the regulator's approval to acquire control of an insurance company (the "PE Stipulations").[2] State insurance regulators are not currently required by the NAIC to impose the PE Stipulations listed in the *Financial Analysis Handbook* with respect to any particular transaction or acquirer; rather, the PE Stipulations serve as guidance that a state insurance regulator could consider in determining whether, and if so on what terms, to approve a particular transaction.

Following the NAIC's adoption of this guidance, there has been a substantial increase in private equity investments in insurers—including, in particular, in the life insurance and annuities sector.[3] Over the past year, this increased activity has resulted in new inquiries from regulators and legislators into whether additional guidance or standards are needed in order to mitigate potential risks to insurance carriers stemming from private equity ownership.[4] The FSTF held an initial discussion on this topic on September 30, 2021, following which the NAIC undertook a nearly year-long initiative of developing and obtaining interested parties' comments on the NAIC List, culminating with the adoption of the NAIC List by the NAIC Executive (EX) Committee and Plenary on August 13, 2022.

The NAIC's efforts in this area—including the NAIC List—are intended to apply broadly to any insurance company engaged in the specified activities; as the official name of the NAIC List suggests, the regulatory considerations are "not exclusive" to private equity-owned insurers. In parallel, as described under *Related Developments* below, considerations related to private equity ownership of insurance companies are also being monitored by both the Federal Insurance Office ("FIO") and members of the U.S. Congress, as well as by the International Association of Insurance Supervisors ("IAIS") and the European Insurance and Occupational Pensions Authority ("EIOPA").

While the NAIC's work on the considerations set forth in the NAIC List is currently in its early stages (with certain exceptions, as described below), the key regulatory initiatives that could be developed as a result of this work include the following:

- New disclosures to be included in Form A filings submitted by persons proposing to acquire U.S. insurance companies and/or requirements that state insurance regulators impose certain commitments on such persons as part of the Form A review and approval process;
- New disclosure requirements, in Form A filings and/or periodic regulatory filings submitted by insurance companies, relating to persons that do not meet the statutory presumption of "control" of the insurance company (*i.e.*, generally, direct or indirect ownership of 10% or more of the issued and outstanding voting securities of the insurance company), designed to help regulators determine whether such persons exercise control over the insurance company in other ways, such as via board or management representation or contractual arrangements;

- More stringent regulatory requirements (*e.g.*, risk-based capital treatment, asset adequacy analysis requirements, statutory reporting requirements) for insurance company investments in structured securities;
- New requirements or standards to be imposed on investment management agreements (“IMAs”) between insurance companies and affiliated or non-affiliated asset managers (*e.g.*, with respect to fees payable under such agreements, termination provisions in such agreements, and/or the amount of discretionary authority granted in such agreements to the asset manager);
- New standards relating to maximum interest rates on surplus notes issued by insurance companies; and/or
- New regulatory requirements relating to reinsurance arrangements pursuant to which U.S. insurance companies cede insurance business to offshore reinsurers or captives.

THE NAIC LIST AND RELATED WORK STREAMS

Over the last year, some state insurance regulators and NAIC staff members have expressed concerns regarding private equity ownership or investment, and other complex investments in, insurance companies. These concerns were distilled by the MWG into a list of 13 regulatory considerations, all of which appear in the NAIC List—along with specific action items designed to address them.

The 13 regulatory considerations set forth in the NAIC List are as follows:

1. “Regulators may not be obtaining clear pictures of risk due to holding companies structuring contractual agreements in a manner to avoid regulatory disclosures and requirements. Additionally, affiliated/related-party agreements impacting the insurer’s risks may be structured to avoid disclosure (for example, by not including the insurer as a party to the agreement).”
2. “Control is presumed to exist where ownership is equal to or greater than 10%, but control and conflict of interest considerations may exist with less than 10% ownership. For example, a party may exercise a controlling influence over an insurer through Board and management representation or contractual arrangements, including non-customary minority shareholder rights or covenants, [IMA] provisions such as onerous or costly IMA termination provisions, or excessive control or discretion given over the investment strategy and its implementation. Asset-management services may need to be distinguished from ownership when assessing and considering controls and conflicts.”
3. “The material terms of the IMA and whether they are arm’s length or include conflicts of interest — including the amount and types of investment management fees paid by the insurer, the termination provisions (how difficult or costly it would be for the insurer to terminate the IMA) and the degree of discretion or control of the investment manager over investment guidelines, allocation, and decisions.”

4. "Owners of insurers, regardless of type and structure, may be focused on short-term results which may not be in alignment with the long-term nature of liabilities in life products. For example, investment management fees, when not fair and reasonable, paid to an affiliate of the owner of an insurer may effectively act as a form of unauthorized dividend in addition to reducing the insurer's overall investment returns. Similarly, owners of insurers may not be willing to transfer capital to a troubled insurer."

5. "Operational, governance and market conduct practices being impacted by the different priorities and level of insurance experience possessed by entrants into the insurance market without prior insurance experience, including, but not limited to, PE owners. For example, a reliance on [third-party administrators] due to the acquiring firm's lack of expertise may not be sufficient to administer the business. Such practices could lead to lapse, early surrender, and/or exchanges of contracts with in-the-money guarantees and other important policyholder coverage and benefits."

6. "No uniform or widely accepted definition of PE and challenges in maintaining a complete list of insurers' material relationships with PE firms[….]"

7. "The lack of identification of related party-originated investments (including structured securities). This may create potential conflicts of interests and excessive and/or hidden fees in the portfolio structure, as assets created and managed by affiliates may include fees at different levels of the value chain. For example, a [collateralized loan obligation ("CLO")] which is managed or structured by a related party."

8. "Though the [NAIC statutory financial statement] blanks include affiliated investment disclosures, it is not easy to identify underlying affiliated investments and/or collateral within structured security investments. Additionally, transactions may be excluded from affiliated reporting due to nuanced technicalities. Regulatory disclosures may be required to identify underlying related party investments and/or collateral within structured security investments. This would include, for example, loans in a CLO issued by a corporation owned by a related party."

9. "Broader considerations exist around asset manager affiliates (not just PE owners) and disclaimers of affiliation avoiding current affiliate investment disclosures[….]"

10. "The material increases in privately structured securities (both by affiliated and non-affiliated asset managers), which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency[….]"

11. "The level of reliance on rating agency ratings and their appropriateness for regulatory purposes (*e.g.*, accuracy, consistency, comparability, applicability, interchangeability, and transparency)."

12. "The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above… Considerations have also been raised regarding the RBC treatment of PRT business[….]"

13. "Insurers' use of offshore reinsurers (including captives) and complex affiliated sidecar vehicles to maximize capital efficiency, reduce reserves, increase investment risk, and introduce complexities into the group structure."

In addition to current plans for addressing the 13 considerations (described further below), state insurance regulators have expressed a desire to meet with industry representatives to discuss both the incentives behind private equity ownership of insurers and any concerns members of the industry may have with such ownership. These discussions, if and when they occur, may result in revisions or additions to the work streams described below.

The NAIC's review of the 13 regulatory considerations and its action plan to respond to them are currently in their early stages—although, as described below, two key components of the action plan (*i.e.*, the Related Party Reporting Provisions and the AAT Guideline described below) were adopted by the NAIC on August 12, 2022 and August 13, 2022, respectively, and will become effective as of December 31, 2022 without any further action required by state legislatures or insurance regulators.

Expansion and Potential Mandatory Use of the PE Stipulations. The NAIC List provides that the MWG is considering whether any stipulations should be added to the existing list of PE Stipulations, as well as whether any of the PE Stipulations should be made mandatory in the context of a state insurance regulator's review of a proposed acquisition of control of an insurance company (*i.e.*, the "Form A" process). Moreover, the NAIC List notes that state insurance regulators are considering using PE Stipulations "beyond the Form A acquisition process (*e.g.*, for insurers acquired in the past)."

New Form A Disclosures. The NAIC List includes a referral to the NAIC Group Solvency Issues (E) Working Group (the "Group Solvency Working Group") to consider adding "optional" disclosures to Form A filings to be requested by the regulator at the regulator's discretion when "unresolved regulatory concerns exist with the acquisition" concerning:

- the applicant's goal in acquiring the insurer;
- how the applicant will be paid and in what amounts;
- the applicant's ability to provide capital support to the insurer if needed; and
- information disclosed to the applicant's investors (including copies of disclosures provided to such investors).

The NAIC List also includes a referral to the NAIC Risk-Focused Surveillance (E) Working Group (the "RFS Working Group") to consider adding "optional" disclosures to Form A filings to be requested by the regulator at the regulator's discretion concerning the provisions of any IMA to which an insurer will become a party as a result of the transaction, including, *e.g.*, with respect to unique termination clauses and use of sub-advisors with the potential for additive fees.

Capital Maintenance Agreements. The NAIC List includes a referral to the RFS Working Group to consider capital maintenance agreements, including suggesting guidance for the appropriate entities to provide them and considering ways to make them stronger. This referral appears to have been made in response to the concern stated in Item (4) in the NAIC List that "owners of insurers may not be willing to transfer capital to a troubled insurer," raising the possibility that the purpose of this referral is to consider whether certain parties proposing to acquire control of an insurance company should be required, as part of the Form A approval process, to execute a capital maintenance agreement with respect to the insurance company.

Additional Disclosures about Owners of Less than 10% of Voting Securities. The NAIC List includes a referral to the Group Solvency Working Group to consider additional disclosures that would be helpful to regulators in identifying whether a person that directly or indirectly owns less than 10% of the issued and outstanding voting securities of an insurance company nonetheless should be considered to control such insurance company (*e.g.*, as a result of board or management representation or contractual arrangements). Such disclosures could include additional questions to be included in a Form A filing and/or in periodic regulatory filings or disclosures, such as the annual Form B insurance holding company registration statement filings.

Additional Disclosures regarding "Related Party" Investments. On August 12, 2022, the NAIC Financial Condition (E) Committee adopted revisions to *SSAP No. 25 – Affiliates and Other Related Parties* ("SSAP 25"), *SSAP No. 43R – Loan-Backed and Structured Securities* and the NAIC statutory financial statement blanks (collectively, the "Related Party Reporting Provisions")[5] that require additional reporting, via a new code included in statutory financial statements, of investment transactions between an insurance company and "related parties"—which are defined in SSAP 25 as including entities that have common interests as a result of ownership, control, affiliation or by contract (*i.e.*, the term "related party" is intentionally broader than the term "affiliate" as it is used in the NAIC *Insurance Holding Company System Regulatory Act (Model #440)* (the "Model HCA")). Among other things, "related parties" include affiliates of the insurance company; the principal owners, directors and officers of the insurance company; the management of the insurance company and its affiliates; any party that can "significantly influence" the management or operating policies of the insurance company (which may include certain providers contracting with the insurance company); 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.[6]

Further, the Related Party Reporting Provisions expressly provide that a loan-backed or structured security will be subject to reporting as a related party investment if:

- 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
- a related party or affiliate was involved in sponsoring or originating the security or any type of underlying servicing arrangement.

The Related Party Reporting Provisions state that it is "erroneous" to conclude that the inclusion of a non-related intermediary, or the presence of non-related assets, in a structure "predominantly comprised of related party investments" eliminates the reporting requirements for related party investments. It is noteworthy that these reporting requirements will apply even in circumstances where the underlying collateral does not predominantly consist of securities issued by the insurance company's affiliates; the mere fact that a related party was involved in sponsoring or originating the security or an underlying servicing arrangement is sufficient for the related party reporting requirements to apply.

The NAIC List identifies the Related Party Reporting Provisions, along with work by the RFS Working Group, as the "first step" before state insurance regulators will consider whether additional guidance is needed to address concerns related to potential conflicts of interests and "excessive and/or hidden fees" in related party-originated investments, including structured securities. The Related Party Reporting Provisions will become effective as of December 31, 2022, and, because they constitute statutory accounting guidance, no further action by the states will be required to implement them on a nationwide basis.[7]

IMA Provisions. The NAIC List includes a referral to the RFS Working Group to review considerations related to IMA provisions, such as unique termination clauses, the use of sub-advisor agreements with additive fees, and whether investment management fees, when not fair and reasonable, may effectively act as a form of unauthorized dividend from the insurance company. In addition, the MWG has discussed whether, given the increasing prevalence of bespoke IMAs, it makes sense for the RFS Working Group's work to be tied to the work of the NAIC Valuation of Securities (E) Task Force ("VOSTF") or the NAIC Securities Valuation Office ("SVO").

New Standards and Disclosures for Structured Securities. The NAIC has undertaken several work streams designed to help ensure that insurance companies' investments in structured securities (such as

CLOs) are supported by appropriately modeled assets and carry appropriate risk-based capital ("RBC") charges, and that further information about these investments is disclosed to state insurance regulators.

First, on August 13, 2022, the NAIC Executive (EX) Committee and Plenary adopted a new actuarial guideline, Actuarial Guideline LIII, *Application of the Valuation Manual for Testing the Adequacy of Life Insurer Reserves* (the "AAT Guideline"),[8] which specifies additional asset adequacy analysis requirements for life insurers, including enhanced requirements for certain "complex assets" in which these insurers invest. The AAT Guideline states that certain regulators have expressed a concern that there is a "lack of uniform practice" in the implementation of asset adequacy analysis, and that there is a "variety of practice" in incorporating the risk of certain complex assets that are increasingly being acquired by life insurers into asset adequacy testing.[9] 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 new 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.[10]

The AAT Guideline is explicitly designed to: (i) help identify reserve adequacy and claims-paying ability in moderately adverse conditions, including conditions negatively impacting cash flows from complex assets; (ii) clarify elements to consider in establishing margins on asset-related assumptions; (iii) ensure recognition that higher expected gross returns from assets are, to some extent, associated with higher risk, and that assumptions fit reasonably within the risk-return spectrum; (iv) require sensitivity testing regarding complex assets; (v) identify expectations in practice regarding the valuation of complex assets within asset adequacy analysis; and (vi) require additional documentation of investment fee income relationships with affiliates of, or "entities close to," the insurance company. The AAT Guideline requires that the new documentation, sensitivity test results and attribution analysis required by the AAT Guideline be included in the insurer's annual actuarial memorandum required by section VM-30 of the NAIC Valuation Manual. The AAT Guideline will become effective for asset adequacy analysis of reserves reported in the December 31, 2022 statutory annual statement and all subsequent statutory annual statements. Because the AAT Guideline is an actuarial guideline, no further action by the states will be required to implement its requirements on a nationwide basis.[11] The AAT Guideline applies only to life insurers with: (i) over $5 billion of general account actuarial reserves and non-unitized separate account assets, or (ii) over $100 million of such reserves and assets and over 5% of supporting assets (selected for asset adequacy analysis) that meet the definition of "Projected High Net Yield Assets."

Second, the NAIC Risk-Based Capital Investment Risk and Evaluation (E) Working Group ("RBCIREWG") has received direction from the NAIC Financial Condition (E) Committee that, as a priority item on the RBCIREWG's agenda, it should engage in a comprehensive project to determine the appropriate RBC charges for all tranches of CLOs. This will be a long-term project for RBCIREWG, and it is anticipated that it will work with the American Academy of Actuaries to develop and finalize this proposal.

Third, while the RBCIREWG's work on determining the RBC charges for all tranches of CLOs continues, the RBCIREWG will also engage in a project to develop an interim solution to develop the appropriate RBC charge for residual tranches[12] of CLOs—which solution would be in effect until the comprehensive CLO RBC framework is finalized and adopted. The reason for the perceived necessity to adopt an interim solution applicable to the RBC treatment of residual tranches relatively quickly is a concern shared by some state insurance regulators that insurance companies are currently able to obtain a better RBC charge for investing in the entirety of a CLO issuance instead of directly investing in the collateral underlying the same CLOs—which these regulators believe may result in RBC charge arbitrage. This concern was previously discussed at length by VOSTF and SVO staff and is also articulated in the memorandum sent to VOSTF by the SVO on May 25, 2022 (the "SVO Memorandum").[13] Among other things, the SVO Memorandum recommends that the RBC factors for CLO residual equity be increased, in certain circumstances, to as high as 75% to 100%. This specific proposal will not necessarily be binding on RBCIREWG as it undertakes this work, and, speaking at the August 11, 2022 meeting of the RBCIREWG, the representative of its Chair, Philip Barlow (District of Columbia Department of Insurance, Securities and Banking), stressed that the RBCIREWG will welcome feedback from interested parties as to the appropriate solution for addressing this concern.

As part of this work, the RBCIREWG may also review and revise RBC charges applicable to residual tranches of structured securities other than CLOs. If undertaken, this work would not necessarily be an interim solution, since the RBCIREWG's upcoming comprehensive project designed to determine RBC charges for all tranches of CLOs does not currently relate to any other types of structured securities (and, therefore, would not be able to override the RBCIREWG's work on RBC charges for residual tranches of such securities).

Fourth, in response to the concerns described in the SVO Memorandum, on August 11, 2022, VOSTF directed the SVO to begin the work needed to remove CLOs from the list of securities that are eligible for filing exempt ("FE") status[14] for purposes of determining their NAIC Designations.[15] As a result of this proposal, it is anticipated that CLOs will instead become subject to a financial modeling process by the SVO, which is expected to generally function similarly to the financial modeling process that is currently applicable to insurance company investments in residential mortgage-based securities ("RMBS") and commercial mortgage-backed securities ("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. The NAIC's stated goal in implementing this new financial modeling process for CLOs is to "normalize" their NAIC Designations, such that all CLOs would be subject to the same modeling results—and also respond to state insurance regulators' concerns about RBC charge arbitrage described above. This process will differ from the current procedure for assigning NAIC Designations to CLOs, pursuant to which, if a CLO is assigned a rating by an eligible rating agency, the CLO is not subject to filing requirements with the SVO and instead has an NAIC Designation assigned to it by reference to the rating assigned to it by the applicable rating agency. During the VOSTF's meeting on August 11, 2022, it was stressed that the process for developing the modeling approach for CLOs will be fully transparent and open to feedback from the industry and other interested parties, and that the final implementation of the SVO's financial modeling for CLOs will not occur until year-end 2023 at the earliest.

Fifth, the NAIC List includes a referral to the NAIC Examination Oversight (E) Task Force that is intended to help state insurance regulators obtain further information concerning CLOs and other structured securities in which insurance companies invest—presumably, as part of the examination process. This referral includes: (i) in circumstances where there is a concern with an insurance company's potential exposure to affiliates within its CLO holdings, enabling state insurance regulators to request that the insurance company provide copies of monthly collateral reports that are distributed to CLO investors, (ii) enabling state insurance regulators to obtain more information concerning the underlying portfolio companies affiliated with a CLO manager, in order to help quantify the insurance company's potential exposure to affiliates and related parties, and (iii) a request to consider whether NAIC staff can provide tools and/or reports that would help state insurance regulators target CLOs and structured securities to be scrutinized more closely.[16]

Additional Transparency for Privately Structured Securities. The NAIC List includes several action items in response to state insurance regulators' concerns that privately structured securities[17] in which insurance companies invest may introduce additional risk or not be transparent to regulators. In discussing these concerns, the MWG has focused both on whether the risks of these investments are appropriately included in an insurance company's financial results and on ensuring that insurance companies have the appropriate governance and internal controls for these investments. The NAIC List notes that state insurance regulators have expressed support for the proposal pending at VOSTF that would add various data to statutory financial statements concerning securities in which insurance companies invest, including market yields for such securities. This data 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, which originates from the SVO, has been subject to significant pushback from the industry (the new disclosure requirements are considered burdensome by some industry members), but may now have a greater chance of being adopted given the concerns delineated in the NAIC List. The NAIC List also notes that the work of certain other NAIC groups may be helpful in resolving these concerns, including the new items that will be included in actuarial memoranda as required by the AAT Guideline (as described above), as well as the ongoing project of the NAIC Statutory Accounting Principles (E) Working Group ("SAPWG") that is intended to result in more granular reporting of insurance company investments in Schedule D of the statutory financial statements. The NAIC List notes that state insurance regulators will wait until further information stemming from these initiatives is available before deciding whether any further work is needed to address any remaining concerns with insurance companies' investments in privately structured securities.

Appropriateness of Reliance on Rating Agency Ratings. VOSTF and the SVO have been separately considering 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. These efforts have resulted in the formation of an ad hoc group composed of certain NAIC staff members, insurance regulators and industry representatives to further study the issue and develop a framework for assessing rating agency reviews. The NAIC List notes that this project is expected to be a multi-year project and will involve, *inter alia*, discussions with rating agencies, and that the MWG will for the time being monitor the work of this ad hoc group in lieu of making any specific recommendations to address the concerns with rating agency ratings that are described in the NAIC List. Speaking at the August 11, 2022 meeting of VOSTF, the representative of its Chair, Carrie Mears (Iowa Division of Insurance), noted that the ad hoc group is continuing to meet and will hold further meetings and discussions with rating agencies in the future, and that it has not yet finalized any deliverables.

Pension Risk Transfers. The NAIC List states that MWG was "comfortable" that the AAT Guideline will address the concerns that pension risk transfer ("PRT") transactions may be supported by complex investments that may not be appropriately reflected in the insurance company's reserves. However, the MWG has provided a referral to SAPWG to consider additional disclosures that would be appropriate relating to PRT business. Examples of disclosures on which the MWG focused during its discussions of this topic include disclosures concerning the risks to an insurance company's general account from its separate account PRT business (*e.g.*, if the separate account is supported by a general account guarantee) and whether the separate account is able to support its own liabilities.

The NAIC List also notes that MWG aims to review "applicability of Department of Labor protections resulting for pension beneficiaries in a PRT transaction"; references regulators' concerns regarding "potential differences between the pension benefit and the group annuity"; and indicates that MWG has directed NAIC staff to perform further research on this subject for the MWG to address "in the near future."

As to RBC treatment for PRT business, the NAIC List states that MWG has determined that no further action is needed on this item at this time, given that a new longevity risk transfer charge was included in the 2021 Life RBC formula as a result of the work completed by the NAIC Longevity Risk (E/A) Subgroup.

Use of Offshore Reinsurers, Captives, and Sidecars. The NAIC List notes that state insurance regulators have held "candid conversations" about aspects of the U.S. regulatory regime that may be driving U.S. insurers to utilize offshore reinsurers, and that specific action on this item will be deferred until more feedback concerning these considerations is gathered from both the industry and insurance regulators in certain offshore jurisdictions where reinsurers may be domiciled. As part of this effort, the MWG has already begun engaging in confidential discussions with certain industry members to obtain further information about the use of offshore reinsurers, captives and sidecars. As a potential item for future consideration, the NAIC List notes that the Model HCA could be amended to include disclosures concerning the benefits (reserves, capital, etc.) provided to a U.S. domestic insurer from ceding business to an affiliate non-U.S. reinsurer.

Surplus Notes – Interest Rates. The NAIC List includes a referral to the RFS Working Group to consider appropriate interest rates on surplus notes "given their special regulatory treatment." As part of this referral, the RFS Working Group will consider whether floating interest rates on surplus notes are appropriate. Currently, *Statement of Statutory Accounting Principles No. 41 – Revised, Surplus Notes*, which is the key authoritative NAIC document on surplus notes, does not include any restrictions on interest rates (fixed or floating) on surplus notes, although such restrictions may be present in the laws of some states.

Owners' Lack of Experience in Insurance Operations. The NAIC List provides that, in the future, the NAIC may consider undertaking actions aimed to ensure that owners of insurance companies have the requisite knowledge and experience in operating an insurance business. Specific items to address this consideration include, *e.g.*, optional Form A disclosures, guidance for less experienced states, more detailed guidance for financial examinations, and market conduct-related items for intentional actions by new owners that are contrary to the requirements of state insurance laws. The MWG will consider this topic further before any new referrals are made to the appropriate NAIC working groups.

RELATED DEVELOPMENTS

Senator Sherrod Brown Urges Action by the NAIC and FIO Relating to Private Equity Investment in the Insurance Industry

On March 16, 2022, Senator Sherrod Brown (D-OH, Chair of the Senate Banking, Housing and Urban Affairs Committee) sent a letter to FIO and the NAIC, in which he expressed concern regarding the "growing number of insurance obligations being sold to alternative asset managers, like private equity firms." Senator Brown's letter identified a number of potential concerns regarding private equity-owned insurers, such as "aggressive investment strategies pursued by private equity-controlled insurers," "risks to transparency" that arise from the transfer of insurance obligations to "private equity firms and asset managers [that] are not public companies," and "risks to the broader economy related to investment strategies, lending and other shadow-bank activities pursued by these companies."

NAIC and FIO Responses. The NAIC and FIO sent response letters to Senator Brown on May 31, 2022 and June 29, 2022, respectively, in which they described the relevant trends in the life insurance industry and the global markets, the key aspects of insurance company solvency regulation in the United States, and the ongoing NAIC efforts in this area that are described above. In particular, FIO's letter[18] identifies the following areas as priorities for FIO as it continues to monitor private equity investments in insurers:

- The impact of the growing volume of investments by insurance companies in structured securities and other higher yielding but less liquid investments on the insurance companies' liquidity;
- Reviewing current supervisory and capital frameworks and working with state insurance regulators to ensure that these frameworks are aligned with the growth and nature of alternative investments, including the linkage between affiliated origination platforms, securitization strategies and asset allocation approaches;
- Monitoring the growth of offshore reinsurance to affiliates and non-affiliates, assessing why it occurs, and understanding "whether regulatory capital arbitrage opportunities, tax advantages, and other potential gaps that are not under the oversight of U.S. regulators are obscuring (or even amplifying) the level of risk stemming from these activities"; and
- Potential conflicts of interest issues that could arise from investment fee structures and sourcing from affiliated origination platforms.

FIO's letter notes that it has been engaging with the NAIC on these issues, as well as ways in which the U.S. state insurance regulatory framework could be modified to address them, and characterizes the NAIC's current work plan for responding to these concerns as being "broadly aligned" with FIO's priorities.

Response from Senator Brown. On August 5, 2022, Senator Brown sent follow-up letters to the NAIC[19] and FIO,[20] in which he warned that "increasing prevalence of 'alternative and other non-traditional asset classes' across the insurance industry, among traditional and private equity-owned insurers," as well as "leverage among life insurance companies[, which] was near the highest levels in recent decades" may signify a "trend in insurance investment [that] may mirror the risk-taking behavior financial institutions undertook that led to the financial crisis and had spillover effects across the economy." Accordingly, Senator Brown recommends that FIO "should work to examine the growth of offshore reinsurance markets and increased risk-taking behavior across the life insurance industry, which could contribute to increased systemic risk across the financial system." Each of the letters notes that Senator Brown "look[s] forward to discussing these issues and broader insurance industry matters at an upcoming hearing before the Committee on Banking, Housing, and Urban Affairs."

IAIS and EIOPA Focus on Private Equity Ownership of Insurers and Acquisition of Run-Off Books of Business.

The Global Insurance Market Report (GIMAR) released by the International Association of Insurance Supervisors ("IAIS") in November 2021[21] 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," including "increased exposures to private placements and private label asset-backed securities," such as CLOs. The same report also stated that private equity-owned life insurers have "complex group structures" and "may take on risks that could leave policyholders more vulnerable to financial loss," including engaging in riskier capital, liquidity and investment strategies. These themes are similar to those being explored by the NAIC and FIO, but have broader reach, since the IAIS is a membership organization of insurance supervisors and regulators from both U.S. and non-U.S. jurisdictions.

On April 7, 2022, EIOPA, the European Union supervisory authority for insurance and pensions, issued a *Supervisory Statement on Supervision of Run-Off Undertakings* (the "Supervisory Statement").[22] The Supervisory Statement relates to the acquisition of run-off undertakings generally, but devotes special consideration to the involvement of private equity and similar investment vehicles. "Run-off" describes portfolios of policies or books of business where an insurance company has ceased writing new business or old years of an active portfolio. EIOPA remarks that the number and size of run-off portfolios is increasing and that growing interest has been observed from investors (in particular private equity) acquiring these portfolios, whereby an investing insurance company will acquire the portfolio of run-off

policies (also called legacy business), typically by means of reinsurance or a statutory or court-approved transfer of the liabilities to the acquirer. According to EIOPA, since the private equity "investment horizon is usually shorter than more traditional shareholders, there is a risk that capital is pulled out of the target undertaking with potential negative impact on policyholders' protection." The Supervisory Statement recommends that European national supervisory authorities "should consider the track record of the involved private equity party and its owners and assess the possible consequences of an early withdrawal from the investment." According to the Statement, acquisitions of run-off portfolios should be subject to additional requirements and considerations on a change of control, with European supervisors potentially requiring additional commitments (*e.g.*, loss transfer agreements and/or collateral) and undertaking an enhanced assessment of the acquirer and its businesses. EIOPA states that because private equity investors may seek to increase the return on their investments, European supervisory authorities should consider: if policies with profit-sharing are affected, assessing if the run-off transaction leads to an unbalanced distribution of risk and reward; and, if leverage is used to finance the run-off acquisition, that the acquirer should demonstrate its ability to serve the debt or refinance any remaining amount at maturity even under unfavorable economic conditions (*e.g.*, by reverse stress tests). The Supervisory Statement indicates that legacy platforms backed by private equity are often embedded in "complex group structures" and, since ownership changes may extend to several entities, it may be necessary for supervisory authorities to consult with several regulatory authorities in connection with a potential run-off acquisition. Finally, EIOPA notes that, with regard to dividend and coupon payments, the supervisory authority "needs to carefully examine the funding structures involved to improve the predicted return on equity (RoE) of the run-off undertaking/portfolio and the time horizon in relation the RoE," and that the return expectations communicated to investors need to be realistic.

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ENDNOTES

[1] NAIC, Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers (Aug. 13, 2022), *available at* https://content.naic.org/sites/default/files/national_meeting/EX-PlenaryAug13_Materials.pdf, Attachment Fourteen.

[2] The complete current list of the PE Stipulations is included in the "Form A – Statement Acquisition of Control of or Merger with a Domestic Insurer" procedures section of the Financial Analysis Handbook. *See* NAIC, Financial Analysis Handbook, *available at* https://content.naic.org/sites/default/files/publication-fah-zu-financial-analysis-handbook.pdf, *at* pp. 724-725.

[3] *See*, *e.g.*, FIO, Annual Report on the Insurance Industry (Sept. 2021), Section II.B.4, *available at* https://home.treasury.gov/system/files/311/FIO-2021-Annual-Report-Insurance-Industry.pdf.

[4] In a related development, on April 19, 2022, the New York State Department of Financial Services issued a Circular Letter that, among other things, expressed a concern that certain persons that do not meet the statutory presumption of "control" of an insurance company (*i.e.*, generally, direct or indirect ownership of 10% or more of the issued and outstanding voting securities of the insurance company) may exercise a controlling influence over the insurance company in another manner, such as via board and management representation or contractual arrangements. The subject matter of this Circular Letter overlaps with some of the concerns included in the NAIC List—and, in fact, the NAIC List notes that a copy of this Circular Letter has been distributed to all members of the MWG and interested regulators. For a more detailed discussion of this Circular Letter, *see* Sullivan & Cromwell LLP, New York Department of Financial Services Issues Circular Letter Regarding Insurance Acquisitions and Disclaimers of Control, *available at* https://www.sullcrom.com/files/upload/sc-publication-nydfs-guidance-on-insurance-acquisitions-and-disclaimers-of-control.pdf.

[5] *See* NAIC Financial Condition (E) Committee, August 12, 2022 Agenda and Meeting Materials, *available at* https://content.naic.org/sites/default/files/national_meeting/Materials-ECmte.pdf, Attachment Two.

[6] Under state insurance holding company acts, the state insurance regulator typically has the authority to grant a disclaimer of affiliation or determination of non-control with respect to persons making potential investments in an insurance company. If granted, the disclaiming person will not be deemed an "affiliate" of the insurance company for purposes of the insurance holding company laws and will be relieved of the reporting and other obligations to which "control" persons of the insurance company are subject. The Related Party Reporting Provisions are a new step in the NAIC's recent statutory accounting initiative pursuant to which increasingly granular information has been required to be reported in statutory financial statements concerning investors that have been granted a disclaimer of affiliation or a determination of non-control. This initiative commenced in 2020, when the NAIC Blanks (E) Working Group adopted revisions to Schedule Y, Part 3, in the statutory financial statements that require additional disclosures concerning entities with greater than 10% ownership of insurance companies, including a column explicitly disclosing whether any such entity has been granted a disclaimer of affiliation. *See* NAIC Blanks (E) Working Group, Agenda Item #2020-37BWG, *available at* https://content.naic.org/sites/default/files/inline-files/2020-37BWG_Modified.pdf.

[7] The statutory accounting rules set forth in the Accounting Practices & Procedures Manual of the NAIC (the "AP&P Manual") are automatically incorporated into the insurance laws of all U.S. states, subject to deviations a state may promulgate in published regulations pertaining to statutory financial statements. *See*, *e.g.*, 11 NYCRR 83.3 (providing that the AP&P Manual is "adopted in its entirety" in New York, unless any of its provisions conflicts with the requirements set forth in the New York Insurance Law). As a result, in general, revisions to the AP&P Manual

automatically become effective in all U.S. states without any requirement for further action by state legislatures or insurance regulators to implement them.

8 NAIC, Actuarial Guideline LIII – Application of the Valuation Manual for Testing the Adequacy of Life Insurer Reserves (Aug. 13, 2022), *available at* https://content.naic.org/sites/default/files/national_meeting/EX-PlenaryAug13_Materials.pdf, Attachment Four.

9 Some states already impose specific additional asset adequacy analysis requirements on life insurers licensed therein. For example, the New York State Department of Financial Services issues a Special Considerations Letter on an annual basis, which, *inter alia*, imposes additional asset adequacy requirements on life insurers licensed in New York. The AAT Guideline will have a broader scope, since it will be applicable to all U.S. life insurers that meet the materiality criteria described below.

10 The AAT Guideline includes specific numeric criteria for determining whether an "Equity-like Instrument" (*i.e.*, an asset that is in the category of common stock for purposes of RBC C-1 reporting, that is captured on Schedule A or Schedule BA, or that is a bond fund) or an asset other than an "Equity-like Instrument" constitutes a Projected High Net Yield Asset. For example, for assets other than "Equity-like Instruments," this determination is based on a calculation using the investment grade net spread benchmarks set forth in Appendix I to the AAT Guideline.

11 NAIC actuarial guidelines are included in the AP&P Manual. *See* Note 7.

12 In general, the term "residual tranche" of a CLO refers to the equity tranche of the CLO—which is typically also the riskiest tranche, since it is the most subordinated tranche in the CLO capital structure, receiving only residual cash flows after payments are made to holders of the CLO debt tranches.

13 *See* SVO, Risk Assessment of Structured Securities – CLOs (May 25, 2022), *available at* https://content.naic.org/sites/default/files/national_meeting/VOSTF%20Materials%208.11.2022%20v7.pdf, Attachment Ten.

14 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, *inter alia*, 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 bond that qualifies for FE is determined by reference to the rating(s) assigned to such a bond by the applicable rating agencies, as detailed in the table included in Part Three of the P&P Manual. *See* P&P Manual, Part Three – SVO Procedures and Methodology for Production of NAIC Designations, § 25.

15 NAIC Designations are alphanumeric designations that express the opinion of credit quality of a particular investment. *See* P&P Manual, Part One – Policies of the NAIC Valuation of Securities (E) Task Force, § 37. NAIC Designations are used for a variety of purposes, including for statutory reporting, RBC, and, in many states, determining the compliance of certain investments made by insurance companies domiciled in the state with that state's insurance laws.

16 The Related Party Reporting Provisions are another component of the NAIC's work related to structured securities.

In addition, the NAIC is also considering other long-term initiatives that may impact insurance companies' investments in structured securities, including SAPWG's work on: (i) a principle-based definition of a "bond" for statutory accounting purposes, which may result in certain structured securities no longer meeting that definition, and (ii) revisions to Schedule D-1 in the statutory financial statements, which will result in more granular reporting for various types of

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bonds and structured securities. The most recent SAPWG exposures of the principle-based "bond" definition are *available at* https://content.naic.org/sites/default/files/inline-files/Draft%20Bond%20Definition%203-2-22.pdf (definition and examples) and https://content.naic.org/sites/default/files/inline-files/Bond%20IP%20-%203-2-22.pdf (issue paper), while the most recent SAPWG exposures of the Schedule D-1 revisions are *available at* https://content.naic.org/sites/default/files/inline-files/B%20-%207-18-22%20-%2043R%20-%20Option%201%20-%20Schedule%20D%20_0.doc (reporting lines/descriptions) and https://content.naic.org/sites/default/files/inline-files/A%20-%207-18-22%20-%2043R%20-%20General_Instructions.doc (Schedule D-1 instructions).

17 The term "privately structured securities" appears to refer to a security that is structured and issued for a particular group of investors (including an insurance company) by an affiliated or non-affiliated asset manager. These securities may carry a private rating from a rating agency and thus qualify for filing exempt (FE) status, exempting them from review by the SVO—an issue that the NAIC Capital Markets Bureau and its three sub-groups, including the SVO, have long considered to be problematic. *See, e.g.*, NAIC Capital Markets Bureau, Special Report – Growth in Private Ratings Among U.S. Insurer Bond Investments and Credit Rating Differences, *available at* https://content.naic.org/sites/default/files/capital-markets-special-reports-PLR-Rating-Differences.pdf (stating that privately rated securities are "less transparent to the marketplace", and that NAIC staff has "observed disparities between… ratings of the same credit, particularly with [private letter ratings]… some of which [disparities] are significant [and] call into question the quality and comparability of [private letter ratings], and [whether] they will have an adverse impact on capital requirements under the current RBC framework").

18 *See* Federal Insurance Office, Letter to The Honorable Sherrod Brown (Jun. 29, 2022), *available at* https://www.banking.senate.gov/imo/media/doc/fio_85.pdf.

19 *See* Sherrod Brown, Letter to the NAIC (Aug. 5, 2022), *available at* https://www.banking.senate.gov/imo/media/doc/naic_letter1.pdf.

20 *See* Sherrod Brown, Letter to FIO (Aug. 5, 2022), *available at* https://www.banking.senate.gov/imo/media/doc/fio_letter_85.pdf.

21 *See* IAIS, Global Insurance Market Report (Nov. 30, 2021), *available at* https://www.iaisweb.org/uploads/2022/01/211130-IAIS-GIMAR-2021.pdf.

22 *See* Supervisory Statement on Supervision of Run-Off Undertakings (Apr. 7, 2022), *available at* https://www.eiopa.europa.eu/sites/default/files/publications/supervisory_statements/supervisory_statement_on_supervision_of_run-off_undertakings.pdf.

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