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NAIC Private Equity Initiative — Spring 2023 Developments

Spring 2023 Update on the NAIC Initiative Applicable (but Not Exclusive) to Private Equity Ownership of Insurers and Insurer Investment Practices

SUMMARY

In August 2022, the National Association of Insurance Commissioners ("NAIC") adopted a list of 13 regulatory considerations (the "NAIC List"), constituting the NAIC's action plan for addressing various concerns expressed by state insurance regulators related to the increasing number of U.S. insurance companies owned by private equity firms. 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.[1] This memorandum discusses key developments related to this initiative that occurred at the NAIC Spring 2023 National Meeting, which took place on March 21-25, 2023 (the "Spring National Meeting").

BACKGROUND

The NAIC's ongoing work related to the regulatory considerations set forth in the NAIC List is currently primarily focused on a few key areas, many of which are related to insurance company investments. Perhaps most significantly, the NAIC is currently engaged in revising the regulatory framework that applies to insurance companies' investments in structured securities, including updates to the processes pursuant to which credit ratings (*i.e.*, NAIC Designations) are assigned to certain types of structured securities and revisions to the risk-based capital ("RBC") treatment of structured securities. In addition, the NAIC is continuing to consider whether the assignment of NAIC Designations to securities in which insurance companies invest by reference to ratings issued by rating agencies is appropriate for regulatory purposes. Separately, the NAIC is also continuing to assess the use of offshore reinsurance

arrangements, including captives and sidecars, by U.S. insurers.[2] The current status of these ongoing NAIC initiatives and a description of those NAIC List-related initiatives that have already been completed by the NAIC are included in the status document released by the NAIC Macroprudential (E) Working Group ("MWG") in connection with the Spring National Meeting.[3]

UPDATE ON NAIC INITIATIVES RELATED TO THE NAIC LIST

NAIC Designations for CLOs. The NAIC Financial Condition (E) Committee (the "(E) Committee") has adopted amendments to the Purposes and Procedures Manual of the NAIC Investment Analysis Office (the "P&P Manual"),[4] which provide that collateralized loan obligations ("CLOs") will no longer be eligible for filing exempt ("FE") status and will instead be subject to a financial modeling process by the NAIC Structured Securities Group ("SSG") effective as of January 1, 2024.[5]

The specific methodology to be utilized by the SSG for modeling CLOs has not yet been developed. The NAIC Valuation of Securities (E) Task Force ("VOSTF") has formed an ad hoc group that will include NAIC Securities Valuation Office ("SVO")/SSG staff and interested parties for purposes of developing this methodology; this ad hoc group has begun holding regular meetings to work on technical aspects of the methodology.

Separately, the NAIC Statutory Accounting Principles (E) Working Group ("SAPWG") has exposed for public comment proposed revisions to *SSAP No. 43R – Loan-Backed and Structured Securities* to reflect the fact that CLOs will become subject to this financial modeling process.[6]

RBC Factors for Structured Securities. The NAIC 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 various types of structured securities, as well as an interim solution to develop the appropriate RBC charge for residual tranches[7] of such securities. The RBCIREWG's discussions of these two projects initially focused on CLOs; over the past few months, however, the RBCIREWG has repeatedly stressed that these projects will involve the development of RBC charges for all structured assets, not just for CLOs. As the first step in its work, the RBCIREWG intends, as an interim solution, to develop an RBC factor for residual tranches of all structured securities by the end of this year. This accelerated timeline, which will be more condensed than the RBCIREWG's typically rigorous process of developing RBC factors, was adopted because certain state insurance regulators believe that RBC factors for residual tranches need to be revised on an expedited basis. Among other things, certain state insurance regulators (including, for example, representatives of the Virginia and Ohio insurance departments) have expressed concerns regarding the potential adverse impact that deteriorating financial conditions in the global economy could have on CLO residual tranches (*i.e.*, if adverse economic conditions were to cause the underlying loans to default, a CLO's residual tranche could quickly be wiped out). The RBCIREWG will then proceed with the development of a

comprehensive RBC framework for all tranches of CLOs, which will, among other things, replace the interim factor for residual tranches of such securities. Thereafter, the RBCIREWG will develop comprehensive RBC frameworks for other types of structured securities. When assessing the types of structured securities for which comprehensive RBC frameworks should first be developed, the RBCIREWG has indicated that it will likely prioritize the types of structured securities in which U.S. insurance companies are more likely to invest. Speaking at the RBCIREWG's session during the Spring National Meeting, the RBCIREWG's Chair, Philip Barlow (District of Columbia Department of Insurance, Securities and Banking), acknowledged that this approach means that the interim factors may continue to apply for a fairly long time to residual tranches of structured securities that are not a material investment class for the U.S. insurance industry as a whole.

The SVO initially recommended that the existing framework of assigning RBC factors to CLO residual tranches, pursuant to which a CLO residual tranche is treated in the same fashion as an investment in equity and consequently receives an RBC factor of 30%, be expanded to more appropriately account for the CLO residual tranche's tail risk. Under the SVO's proposal, CLO residual tranches would receive NAIC Designations (6.A, 6.B or 6.C) to account for the particular residual tranche's tail risk; RBC factors assigned to CLO residual tranches bearing such NAIC Designations would be 30%, 75% or 100%, respectively (instead of the current framework of assigning a 30% RBC factor to all residual tranches regardless of tail risk). Following a proposal by Mr. Barlow, the RBCIREWG exposed for public comment a modification to the SVO's proposal, pursuant to which, for purposes of developing the interim solution, a single RBC factor would apply to all residual tranches of a structured security regardless of NAIC Designation.[8] The RBC factor itself has not yet been determined by the RBCIREWG and was therefore not part of the proposal exposed for public comment—but, presumably, this RBC factor will likely be higher than the 30% factor that currently applies to CLO residual tranches.

The RBCIREWG has also exposed for public comment an RBC sensitivity test that has been proposed by some industry members as a tool for providing more transparency to state insurance regulators regarding the RBC impact of residual tranches held by an insurance company.[9] Sensitivity tests are intended to provide a "what if" scenario recalculating the insurance company's RBC ratio components (*i.e.*, Authorized Control-Level RBC and Total Adjusted Capital) using a specified alternative for a particular factor in the RBC formula. Mr. Barlow has previously noted that he does not believe that the RBCIREWG's charge of developing an interim solution for residual tranches of structured securities can be met solely with the development of a sensitivity test. Accordingly, if adopted, the sensitivity test would instead function as a regulatory tool that would disclose to a state insurance regulator the RBC impact on a particular insurance company of the structured security residual tranches owned by that company.

The RBCIREWG has also received an update from the American Academy of Actuaries ("AAA") regarding the AAA's work related to the development of a comprehensive RBC methodology for CLOs.

The AAA work includes drafting a model structure document to determine the general parameters for modeling CLOs for RBC purposes. In addition, the AAA is drafting a document containing various definitions of "RBC arbitrage" used by different parties. The SVO has stated that CLOs can provide an opportunity for RBC arbitrage because insurers may currently be able to obtain a better RBC factor for owning all tranches of a CLO backed by a portfolio of bonds than they would by owning such bonds directly.[10] However, the AAA's C1 Work Group has previously questioned this definition of "RBC arbitrage", arguing that packaging underlying loans into a CLO involves "risk transformation" that extends the consideration of CLO risk beyond credit risk and into other types of market risk, such as callability and extension risk, as well as risk related to active trading of loans underlying the CLO.[11] The AAA's C1 Work Group also noted that the concept of "RBC arbitrage" is not applied elsewhere in the RBC C-1 framework, such as with respect to residential mortgage-backed securities, commercial mortgage-backed securities and certain asset-backed securities, and noted that "[it is] not clear to [the Work Group] what the limiting principle is for enforcing a 'No RBC Arbitrage' concept".[12]

Reliance on Rating Agencies. VOSTF is continuing its study of whether the U.S. insurance regulatory framework's current reliance on rating agency ratings to produce NAIC Designations is appropriate for regulatory purposes or whether the SVO should instead be charged with producing NAIC Designations for such securities. As part of this project, VOSTF adopted a new charge for 2023 to identify potential improvements to the FE process to "ensure greater consistency, uniformity, and appropriateness to achieve the NAIC's financial solvency objectives". VOSTF intends to hold meetings with rating agencies to gather further information to continue its work related to this charge. VOSTF has not formally exposed its initial list of questions to rating agencies for public comment, but it has indicated its openness to receiving informal comments thereon from interested parties.[13]

NAIC Designations for "Structured Equity and Funds" Investments. On November 28, 2022, the SVO circulated a memorandum to VOSTF that proposed to remove "structured equity and funds" investments from FE eligibility in light of certain instances of "RBC arbitrage" identified by the SVO from private letter rating ("PLR")[14] filings for such securities.[15] The SVO's proposal defined a "structured equity and funds" investment as "a note issued by, or equity or limited partnership interest in, a special purpose vehicle, trust, limited liability company, limited partnership, or other legal entity type, as issuer, the contractually promised payments of which are wholly dependent, directly or indirectly, upon payments or distributions from one or more underlying equity or fund investments", or any design that circumvents this definition through technical means, but which in substance achieves the same ends (*i.e.*, inclusion of an intervening legal entity between the investor and an underlying equity or fund without a change to the investment risk, where the risk depends, in whole or in part, on the performance of the underlying equity or fund) or poses the same risk.[16] The SVO's proposal would, as drafted, exclude from the FE process all "structured equity and funds" investments—including not only those rated by a rating agency via a PLR, but also those that have been assigned a publicly available rating. The SVO's proposed methodology for

its review and assignment of NAIC Designations to "structured equity and funds" investments would include: (i) a look-through assessment involving a qualitative and quantitative evaluation of the underlying equity or funds investments, and (ii) a credit risk assessment, pursuant to which the SVO would apply "any methodology it deems appropriate to assess the credit risk" of the investment and its underlying securities, which the SVO stated could include a weighted average rating factor ("WARF") methodology[17] or an assessment of the credit risk based on the rating assigned by the rating agency as a starting point and adjusted "as the SVO deems appropriate" to eliminate any RBC arbitrage that may exist as a result of the insertion of the special purpose vehicle or other entity into the structure.[18]

Interested parties expressed a number of concerns with the SVO's proposal, including, among other things: (i) that the definition of "structured equity and funds" investments proposed by the SVO was too broad and could be read to encompass all equity-backed securities, (ii) overlap or potential inconsistencies with other ongoing NAIC projects, including the "principle-based bond" project and the RBCIREWG workstreams referenced above, and (iii) the lack of transparency in the process that the SVO would use to perform credit risk assessment of "structured equity and funds" investments—particularly the fact that the SVO could apply different methodologies to different investments in order to arrive at their NAIC Designations. In response, VOSTF took two significant actions: (i) a referral to SAPWG to clarify how various types of investments within the SVO's proposed definition of "structured equity and funds" are reported for statutory accounting purposes; and (ii) a directive to the SVO to develop a new proposal pursuant to which the SVO would be permitted to challenge an NAIC Designation obtained by reference to a PLR assigned to a security. VOSTF Chair, Carrie Mears (Iowa Insurance Division), requested that the SVO include in this proposal a "very distinct" and transparent process for how the SVO would challenge a PLR. Ms. Mears also likened the new process to a "yellow light" for securities subject to a PLR (between the FE process's "green light" and the SVO filing process's "red light"), and that VOSTF's work on the SVO's initial proposal would be deferred to a later meeting pending development of this "yellow light" framework.

These actions by VOSTF could result in the scope of the SVO's proposal being narrowed to include: (i) only certain types of securities treated as equity-backed for statutory accounting purposes, and/or (ii) only those equity-backed securities that are subject to a PLR. In addition, VOSTF's directive to the SVO is intended to, and may, result in more transparency in the SVO's procedures for assigning credit ratings to any such securities. While these factors appear to address some of the industry participants' concerns, a potential counterbalancing factor is the fact that VOSTF's directive will likely grant to the SVO, for the first time, the power to challenge NAIC Designations obtained by reference to a PLR, possibly with respect to a subset of securities broader than "structured equity and funds" investments.

Use of Offshore Reinsurers, Captives and Sidecars. The MWG has, since the issuance of the NAIC list, held confidential discussions with industry members and certain non-U.S. insurance regulators to

better understand the "true economic impact" of U.S. insurers' use of offshore reinsurers, including captives and complex affiliated sidecar vehicles. In furtherance of this work, the MWG exposed for public comment a reinsurance comparison worksheet intended to enhance state insurance regulators' ability to monitor reinsurance transactions between U.S. insurance companies and offshore reinsurers,[19] to be used in reviewing proposed reinsurance agreements with non-U.S. reinsurers that are subject to a state insurance regulator's review and approval. The instructions incorporated into the worksheet note that regulators may also find it helpful to require completion of the worksheet in connection with existing reinsurance agreements with respect to which the regulator has "significant and material questions/concerns", and also that a regulator would not be prevented from pursuing completion of the worksheet in connection with a reinsurance transaction involving a U.S. reinsurer.

Proposal to Add Further Analytical Capabilities to the SVO. The SVO previously proposed to VOSTF that insurance companies be required to include in their statutory financial statements additional disclosures concerning their bond investments—including, in particular, certain "market data" fields for such investments (*i.e.*, data concerning the price, yield, weighted average life and certain other characteristics of the bond as of the date of the statutory financial statement).[20] In the face of significant industry pushback, VOSTF asked the SVO to consider an alternative approach whereby the SVO could aggregate this data from commercially available sources or, for private securities, from PLR reports required to be filed with the SVO. Because the SVO indicated in its response that taking on these added responsibilities would require enhancements to its existing systems and vendor pricing data; investments in new systems to provide the modeling; more staff for support of these systems and processes; and new data feeds, databases and reporting capabilities, VOSTF circulated a referral to various NAIC committees,[21] requesting feedback on whether the committee supports creating such capabilities within the SVO, how the committee would utilize the new data produced by the SVO, and why having access to such new data would be valuable to the committee,[22] with committee responses due by May 15, 2023.

VAWG Review of AG 53 Reports. As a follow-up to the NAIC's adoption of Actuarial Guideline LIII, *Application of the Valuation Manual for Testing the Adequacy of Life Insurer Reserves* (the "AAT Guideline"), the Valuation Analysis (E) Working Group ("VAWG") indicated that it intends to conduct reviews of life insurance companies' reports required under the AAT Guideline, which are due by April 1 of each year (the first report was due by April 1, 2023), including a targeted review of asset adequacy analyses performed by these life insurance companies in relation to modeling of business supported with "projected high net yield assets" as defined in the AAT Guideline.[23] In the event VAWG identifies any company-specific issues during its review of the AAT Guideline reports, VAWG intends to engage with the insurance company's domiciliary insurance regulator to discuss these issues.

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ENDNOTES

[1] Our previous memoranda described this NAIC initiative in further detail and provided an update on this initiative as of year-end 2022. *See* Sullivan & Cromwell LLP, NAIC Adopts List of Regulatory Considerations Applicable (But Not Exclusive) to Private Equity-Owned Insurers (Aug. 19, 2022), *available at* https://www.sullcrom.com/files/upload/sc-publication-naic-adopts-considerations-related-to-private-equity-owned-insurers.pdf. *See also* Sullivan & Cromwell LLP, Update on NAIC's Private Equity Initiative (Jan. 6, 2023), *available at* https://www.sullcrom.com/files/upload/sc-publication-latest-developments-in-naic-private-equity-initiative.pdf.

[2] The NAIC is also undertaking a long-term project to develop a principle-based definition of a "bond" for statutory accounting purposes that may result in certain structured securities no longer meeting that definition and revisions to statutory financial statement disclosures that will result in more granular reporting for various types of bonds and structured securities. This project commenced in 2019 and predates the NAIC List.

[3] *See* Macroprudential (E) Working Group, Plan for the List of MWG Considerations – PE Related and Other (Mar. 22, 2023), *available at* https://content.naic.org/sites/default/files/national_meeting/Materials-FSTF_7.pdf, Attachment Two.

[4] *See* 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 (Dec. 20, 2022), *available at* https://content.naic.org/sites/default/files/inline-files/2022-004.12b%20-%20PP%20Amend%20to%20Add%20CLO%20to%20Part%20Four%20v3.pdf.

[5] FE refers to the rule set forth in 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.

For a discussion of the financial modeling process to which CLOs are anticipated to be subject, please see our memorandum, Sullivan & Cromwell LLP, NAIC Adopts List of Regulatory Considerations Applicable (But Not Exclusive) to Private Equity-Owned Insurers (Aug. 19, 2022), *available at* https://www.sullcrom.com/files/upload/sc-publication-naic-adopts-considerations-related-to-private-equity-owned-insurers.pdf, pgs. 9-10.

[6] *See* Statutory Accounting Principles (E) Working Group, Maintenance Agenda Submission Form, Ref #2023-02 (Mar. 2023), *available at* https://content.naic.org/sites/default/files/inline-files/23-02%20-%2043R%20-%20CLO%20FM.docx.

[7] In general, the term "residual tranche" of a structured security (such as a CLO) refers to the equity tranche of that structured security.

[8] *See* Risk-Based Capital Investment Risk and Evaluation (E) Working Group, Revised Residuals Structure, *available at* https://content.naic.org/sites/default/files/inline-files/revised-residuals-structure.pdf.

[9] *See* Risk-Based Capital Investment Risk and Evaluation (E) Working Group, Sensitivity Test, *available at* https://content.naic.org/sites/default/files/inline-files/sensitivity-test.pdf.

[10] *See* Securities Valuation Office, 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.

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[11] *See* American Academy of Actuaries, Letter to Valuation of Securities (E) Task Force Re: Proposed Methodology for Modeling CLOs (Feb. 14, 2023), *available at* https://content.naic.org/sites/default/files/call_materials/VOSTF%20Materials%2002.21.2023%20v4.pdf, Attachment C-1, and American Academy of Actuaries C1 Work Group Presentation to the Risk-Based Capital Investment Risk and Evaluation Working Group on CLOs – Status Update (Dec. 14, 2022), *available at* https://www.actuary.org/sites/default/files/2022-12/C1_Presentation_CLOs.pdf, pg. 21.

[12] *See* American Academy of Actuaries C1 Work Group Presentation to the Risk-Based Capital Investment Risk and Evaluation Working Group on CLOs – Status Update (Dec. 14, 2022), *available at* https://www.actuary.org/sites/default/files/2022-12/C1_Presentation_CLOs.pdf, pg. 22.

[13] This list of questions is *available at* https://content.naic.org/sites/default/files/national_meeting/2023%20VOSTF%20Spring%20NM%20Materials%20v4.pdf, Attachment Five.

[14] A PLR is a private rating assigned to a security by a rating agency that is communicated by the rating agency only to the issuer and a specified group of investors and is not publicly released by the rating agency.

[15] *See* NAIC Securities Valuation Office, Proposed Amendment to Define and Add Guidance for Structured Equity and Funds to the P&P Manual (Nov. 28, 2022), *available at* https://content.naic.org/sites/default/files/national_meeting/2023%20VOSTF%20Spring%20NM%20Materials%20v4.pdf, Attachment Three.

[16] *Id.* at pg. 10.

[17] The WARF methodology is an existing methodology used by the SVO for assessing credit risk of certain investments. Typically, application of the WARF methodology involves determining a "factor" for each underlying investment based on that underlying investment's credit risk. The market value of the underlying investment is used to "weight" that factor, and the market value-weighted factors for all underlying investments are summed to determine the investment's overall credit rating—which is then translated into the equivalent NAIC Designation. *See, e.g.*, P&P Manual, Part Three – SVO Procedures and Methodology for Production of NAIC Designations, § 291 (application of the WARF methodology to Schedule BA non-registered private funds with underlying assets having characteristics of bonds or preferred stock).

[18] *See* Securities Valuation Office, Proposed Amendment to Define and Add Guidance for Structured Equity and Funds to the P&P Manual (Nov. 28, 2022), *available at* https://content.naic.org/sites/default/files/national_meeting/2023%20VOSTF%20Spring%20NM%20Materials%20v4.pdf, Attachment Three, at pg. 12.

[19] See Macroprudential (E) Working Group, NAIC Reinsurance Comparison Worksheet Dec 5 2022, *available at* https://content.naic.org/sites/default/files/inline-files/NAIC%20-%20Reinsurance%20Comparison%20Worksheet%20%20Dec%205%202022_0.xlsx.

[20] These market data fields would include the following: (i) market yield of the security, (ii) market price of the security, (iii) purchase yield of the security, (iv) weighted average life of the security (*i.e.*, the average length of time that each dollar of unpaid principal of the security remains outstanding), (v) "spread to average life UST" (i.e., the spread constituting the difference vis-à-vis the interpolated U.S. Treasury bond yield that matches the security's weighted average life), (vi) option-adjusted spread of the security (*i.e.*, the spread between the security's rate and the risk-free rate of return, adjusted to take into account the embedded option), (vii) effective duration of the security (for those securities that have embedded options), (viii) convexity of the security (*i.e.*, the relationship between its price and its yield), and (ix) the VISION system security ID number for the security reported in the SVO's AVS+ system.

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[21] Specifically, this referral was circulated to the (E) Committee, the Financial Stability (E) Task Force, MWG, the Capital Adequacy (E) Task Force, RBCIREWG, the Life Actuarial (A) Task Force, the Financial Analysis (E) Working Group, SAPWG, and the Valuation Analysis (E) Working Group.

[22] *See* Valuation of Securities (E) Task Force, Referral on Additional Market and Analytical Information for Bond Investments (Feb. 13, 2023), *available at* https://content.naic.org/sites/default/files/national_meeting/ecmte-materials-springnm.pdf, Attachment Eleven.

[23] 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.

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