

CLIENT ALERT

NAIC Adopts Plan to Address Considerations Related to Private Equity Owned Insurers

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At the Summer National Meeting of the National Association of Insurance Commissioners (the “NAIC”) on August 13, 2022, the NAIC adopted a plan (the “Work Plan”) to address the list of “Regulatory Considerations Applicable (But Not Exclusive) to Private Equity Owned Insurers” (the “Considerations”). The Considerations were developed by the NAIC over the last year and pertain to the ability of state insurance regulators to effectively monitor the solvency of a legal entity insurer and to assess risks faced by the insurer’s holding company system, particularly in the acquisition context.

The Work Plan was previously adopted by the Financial Condition (E) Committee at the NAIC committee level in July 2022, as reported [here](#), and largely serves to refer the Considerations to other NAIC groups for action. Each Consideration, as published, and a summary of the applicable steps in the Work Plan, is listed below.

1. **Regulatory Consideration One:** 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).

Work Plan: This Consideration was referred to the Group Solvency Issues (E) Working Group (“GSIWG”) for actions, which may include creating optional disclosure requirements that regulators could use in cases when unresolved regulatory concerns exist with the acquisition. Such disclosures could, per the Work Plan, allow regulators to assess “the goal of the potential owner in acquiring the insurer, how the potential owner will be paid

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and in what amounts, and the ability of the potential owner to provide capital support as needed.” GSIWG reported at the Summer National Meeting that it plans to address each Consideration referred to it over the next several months.

2. Regulatory Consideration Two: Control is presumed to exist where ownership is greater than or equal to 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, investment management agreement (“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.

Work Plan: This Consideration was also referred to GSIWG since it overlaps with Consideration One above. GSIWG may consider if questions should be included in Form A applications about less than 10% owners, or if additional disclosure requirements should be added to annual Forms B (Insurance Holding Company System Annual Registration Statement).

3. Regulatory Consideration Three: The material terms of the investment management agreement (“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.

Work Plan: This Consideration was referred to the Risk-Focused Surveillance (E) Working Group, which is reviewing issues related to affiliated agreements and Form D filings but did not meet at the Summer National Meeting. Particular areas of focus regarding IMAs may include unique termination clauses and use of sub-advisors with the potential for additive fees. In addition, within this Consideration, the Risk-Focused Surveillance (E) Working Group may consider appropriate interest rates for surplus notes.

This Consideration was also referred to the Valuation of Securities (E) Task Force (“VOSTF”), which noted at its meeting on August 11, 2022 that it makes sense to tie this Consideration into the work of VOSTF and the Securities Valuation Office (“SVO”) given the increasing prevalence of “bespoke agreements” for investment management.

4. Regulatory Consideration Four: 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

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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.

Work Plan: At the Summer National Meeting, the NAIC adopted a new actuarial guideline for asset adequacy testing, *Actuarial Guideline LIII—Application of the Valuation Manual for Testing the Adequacy of Life Insurer Reserves* (“AG 53”), which addresses this Consideration. AG 53 requires disclosure of additional documentation and analysis related to complex assets supporting businesses including annuities, pension risk transfers, and other life insurer business. AG 53 requires sensitivity testing, helps identify reserve adequacy and claims-paying ability in moderately adverse conditions, identifies expectations for valuing complex assets within asset adequacy analyses, clarifies elements in establishing margins on asset-related assumptions, and requires additional documentation of investment fee income relationships with affiliated entities or entities close to the insurer.

This Consideration was also referred to the Risk-Focused Surveillance (E) Working Group for review related to affiliated agreements and fees, including potentially suggesting guidance for the appropriate entities to provide capital maintenance agreements.

5. **Regulatory Consideration Five:** 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 TPAs 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.

Work Plan: The Macroprudential (E) Working Group (“MWG”), which is charged with overseeing the Considerations, continues to review this Consideration and whether to refer it to another working group. The MWG is also considering whether to enhance the guidance currently in the NAIC Financial Analysis Handbook regarding Form A filings by PE acquirors of insurers.

6. **Regulatory Consideration Six:** No uniform or widely accepted definition of PE and challenges in maintaining a complete list of insurers' material relationships with PE firms. This definition may not be required as the considerations included in this document are applicable across insurance ownership types.

Work Plan: No action will be taken on this Consideration since regulators agree the focus should be on activities and not specific types of owners. This is consistent with the position that the NAIC has expressed throughout its development of the Considerations that the Considerations may apply to any insurer or owner engaged in the specified activities and not exclusively to private equity owned insurers.

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7. Regulatory Consideration Seven: 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.

Work Plan: The Statutory Accounting Principles (E) Working Group (“SAPWG”) developed, and the NAIC adopted in June 2022, revisions to related party transaction reporting requirements effective for year-end 2022, as we previously reported [here](#). These revisions include new codes for reporting related party transactions that identify the role of the related party on new columns on insurers’ year-end investment schedules. Regulators are comfortable with this as a first step to address this Consideration, although the Risk-Focused Surveillance (E) Working Group’s work may also touch on this.

8. Regulatory Consideration Eight: Although the NAIC’s Annual and Quarterly 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.

Work Plan: The approach to this Consideration overlaps with Consideration Seven, above, regarding SAPWG’s new reporting requirements, and Consideration Ten, below, related to privately structured securities.

9. Regulatory Consideration Nine: Broader considerations exist around asset manager affiliates (not just PE owners) and disclaimers of affiliation avoiding current affiliate investment disclosures.

Work Plan: A new Schedule Y, Part 3 is in effect for year-end 2021 to identify all entities with a greater than 10% ownership, regardless of whether a disclaimer is in place. Additionally, SAPWG’s ongoing Bond Project addresses this Consideration. The Bond Project aims to clarify what should be considered and reported as a bond on Schedule D-1 (Long-Term Bonds) of an insurance company’s statutory financial statement with a principles-based bond definition. Reporting changes are expected in 2024, on which we have reported in greater detail [here](#). No action was taken on this item at the Summer National Meeting, but comments on currently proposed reporting changes are due on October 7, 2022.

10. Regulatory Consideration Ten: 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.

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Work Plan: The new AG 53 addresses this Consideration, since it includes disclosure requirements for these risks. This Consideration was also referred to VOSTF. As part of their overall work in assessing appropriate risk-based capital (“RBC”) charges for CLOs, it was reported at VOSTF’s August 11 meeting that the SVO and RBC Investment Risk and Evaluation (E) Working Group will proceed with working on a proposal to ensure that the aggregate RBC factor for owning all tranches of a CLO is the same as that required for owning all of the underlying loan collateral, in order to avoid RBC arbitrage. This change would be implemented at year-end 2023 at the earliest. VOSTF noted that the NAIC agrees with interested parties that CLOs are important to U.S. capital markets and said insurers will still be able to participate in the CLO market, while avoiding the risk of aggressive structuring that puts policyholders in jeopardy.

The Examination Oversight (E) Task Force may also consider ways to allow regulators to obtain more information on CLO investments, such as monthly collateral reports or details regarding the underlying portfolio companies affiliated with a CLO manager.

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

Work Plan: This Consideration was referred to VOSTF, which previously formed an ad hoc group to address this in what is expected to be a multi-year project. At its latest meeting, VOSTF discussed its proposal to add fixed income analytical measures to reporting requirements for bond investments (as an alternative way to measure a security’s risk) and exposed a staff memorandum for comment regarding this proposal. In particular, VOSTF is considering whether the additional data should be gathered and reported to regulators by the SVO (which would require a significant investment of resources by the NAIC) or self-reported by insurers.

12. Regulatory Consideration Twelve: The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above.

Work Plan: This Consideration is intended to be addressed by the new AG 53 that generally aims to ensure claims-paying ability with respect to complex assets. There is also a new charge in the 2021 Life Risk-Based Capital Formula related to longevity risk transfer business, which regulators will monitor. The MWG will continue to review this Consideration.

13. Regulatory Consideration Thirteen: 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.

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Work Plan: The new AG 53 addresses this Consideration since it requires a company to provide commentary on reinsurance collectability and counterparty risk in its asset adequacy analysis. The MWG is considering other actions with respect to this Consideration (such as additional holding company act requirements with respect to affiliated reinsurers), but has deferred specifying those actions pending meetings with industry representatives.

At the Summer National Meeting, MWG Chair Justin Schrader (NE) reported that the MWG plans to monitor the other NAIC groups' activities and provide periodic status updates on the Considerations. In addition, NAIC staff will post a document tracking the 13 Considerations and copies of the referral letters on the MWG website, available [here](#).

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