NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To: Doug Ommen, Commissioner, Valuation of Securities (E) Task Force Chair and

Scott A. White, Commissioner, Valuation of Securities (E) Task Force Vice Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Charles A. Therriault

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

The Financial Condition E Committee adopted this plan with no changes made during its virtual meeting on July 21, 2022. NAIC staff support drafted this referral letter to accomplish the actions captured in the adopted plan. It is unlikely any further modifications will occur to the adopted plan when it is considered for adoption by the full Plenary, but it is a possibility. Please begin work to address these referrals, recognizing the adoption by Plenary is still outstanding.

Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these

discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

(Consideration 3 has been referred to the Risk-Focused Surveillance (E) Working Group. A copy follows since the Valuation of Securities (E) Task Force (VOSTF) is referenced in the regulator discussion.)

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.

Regulator discussion results:

- Refer this item to the NAIC Risk-Focused Surveillance (E) Working Group. Regulators recognized similar dynamics to the first two considerations, but this Working Group was selected because it is already currently focused on a project involving affiliated agreements and Form D filings. Items discussed:
    - Consider training and examples, such as unique termination clauses and use of sub-advisors with the potential for additive fees, and strategies to address these.
        - This included addressing pushback on obtaining sub-advisor agreements as Form D disclosures and some optional disclosures for the Form A.
    - *Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?*
    - Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate; follow any Statutory Accounting Principles (E) Working Group projects related to this topic and provide comments needed.

Risk & Regulatory Consulting (RRC) Comment: "With respect to an Investment Management Agreement, RRC encourages an approach that includes a thorough review of the IMA to ensure it is fair and reasonable to the insurer. In addition to the specific items noted for consideration:

- ♣ Are there detailed and reasonable investment guidelines?
- ♣ Is there sufficient expertise at the insurer and on the insurer's Board to properly assess the performance and compliance of the investment manager?
- ♣ Is the investment manager registered as such under the Investment Advisers Act of 1940, and recognizes the standard of care as a fiduciary?

AIC Comments on “Conflict of Interest, Fees, and Termination” (3 individual comments):

Conflict of Interest

As a general matter, the terms of a contractual agreement should not be viewed as giving rise to a conflict of interest when the agreement is negotiated on an arm’s length basis. Notwithstanding the foregoing, current law provides an established process to address potential conflicts (for example, requirements to appoint independent directors and traditional corporate law processes to ensure fairness and, under certain circumstances, review of transactions by regulators pursuant to Form D filings). Accordingly, investments sourced and allocated by alternative asset managers on behalf of insurance company clients should not, absent other factors, be viewed as presenting a potential conflict of interest, particularly where insurers retain full control over asset allocation (for example, insurers retain control over the asset classes in which they invest, as well as the amounts and periods of time over which such asset exposure is achieved).

Fees

Importantly, as an initial consideration, any fees paid to investment managers cannot be considered in isolation, rather they should be considered on a “net” basis – i.e., on the basis of total return (after fees are taken into account). Sophisticated institutional investors (including insurers) have a successful history of investing in a range of strategies despite certain investment products generally having higher fees than other available investment opportunities. On a net basis, private equity has consistently outperformed more traditional asset classes such as publicly traded stocks and public mutual funds8 Net-of-fees private debt funds have also consistently outperformed bond and equity market benchmarks.9 Insurers continue to recognize the value of investment opportunities that outperform when considered on a net basis.10 This approach has enabled the consistent delivery of industry leading investment results, which ultimately leads to a high level of financial strength.

Termination

Asset managers often dedicate extensive resources at the outset of a new arrangement in support of managing an insurer’s general account assets (e.g., dedicating or reassigning existing personnel, hiring new employees, investing in information technology systems, expanding office space, further enhancing compliance and regulatory processes). As such, and because, in our experience, insurers have the right to terminate their investment management agreements (e.g., upon 30 days’ notice), the desire for external asset managers to seek contractual protections (subject to arms’ length negotiations) should an insurer decide to terminate the arrangement earlier than was originally anticipated by the parties is entirely appropriate.

(Similarly, Consideration 10 has been referred to the Examination Oversight (E) Task Force, but a copy follows since the regulators expressed support for an VOSTF blanks item, determined to forward an RRC comment to the VOSTF, and directed the AIC to follow the VOSTF work related to this Consideration.)

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. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
    a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
    b. *SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG*.

Regulator discussion results:
- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, *regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation*. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. *They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal* and the SAPWG Schedule D revamp project.
- Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency." (*MWG regulators directed this comment be sent to the VOSTF for its existing work related to this Consideration*.)

- ♣ While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
    - Any highly structured transaction is going to lack liquidity.

    - The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.
- A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

AIC Comment on "Privately Structured Securities" (the comment and its 6 bullets follow) – *Regulators asked the AIC to follow the work of* the NAIC Examination Oversight (E) Task Force and *the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed*.

Insurers are increasingly seeking the services of alternative asset managers with significant asset origination capabilities and private credit expertise to manage a portion of their assets, which provide a number of benefits to the insurer and their policyholders. Those benefits include:

- A natural alignment between the long-dated insurance liabilities and the long-term investment approach taken by alternative asset managers, including in the private credit space;
- Alternative asset managers have the ability to source, underwrite and execute private credit transactions that require skill sets, experience, and scale that many insurance companies do not possess in-house;
- Private equity and private credit firms also provide an opportunity for smaller and midsized insurers to access these asset classes, which historically have been the primary purview of large insurers that have the scale to afford in-house asset management functions that can originate these assets, making the industry more competitive to the ultimate benefit of policyholders;
- Engaging asset managers with differentiated capabilities can be more cost efficient than making significant investments in an internal asset management function. By availing themselves of these advantages, insurers can benefit from cost-effective sourcing and origination capabilities in attractive asset classes, resulting in enhanced long-term adequacy margins for policyholders, increased spread/earnings, and more competitive product pricing that inures to the benefit of policyholders;
- Asset-backed security default rates are substantially similar to corporate investment grade debt default rates while CLO default rates are substantially lower than corporate default rates; and
- The focus on private investments is belied by the fact that institutions with higher allocations to private investments have outperformed (with less volatility) those with less.

(Consideration 11 is copied below due to the reference to VOSTF work.)

11. The level of reliance on rating agency ratings and their appropriateness for regulatory purposes (e.g., accuracy, consistency, comparability, applicability, interchangeability, and transparency).
    a. *VOSTF has previously addressed and will continue to address this issue. A small ad hoc group is forming (key representatives from NAIC staff, regulators, and industry) to develop a framework for assessing rating agency reviews. This will be a multi-year project, will include discussions with rating agencies, and will include the inconsistent meanings of ratings and terms.*

Regulator discussion results:

- Regulators agreed to monitor the work of the ad hoc group in lieu of any specific recommendations at this time. Recognizing this will likely be a multi-year project, regulators reserve the right to raise specific concerns that may arise as the various NAIC committee groups work to address this list of considerations.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

Philip Barlow, RBC Investment Risk & Evaluation (E) Working Group Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Dave Fleming/Julie Gann/Charles Therriault/Linda Phelps/Peter Kelly

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

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MWG Consideration Items Referred:

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. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
    a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
    b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal and the SAPWG Schedule D revamp project.
- *Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)*

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency."

- While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
    - Any highly structured transaction is going to lack liquidity.
    - The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.
- A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

AIC Comment on "Privately Structured Securities" (the comment and its 6 bullets follow) – Regulators asked the AIC to follow the work of the NAIC Examination Oversight (E) Task Force and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.

Insurers are increasingly seeking the services of alternative asset managers with significant asset origination capabilities and private credit expertise to manage a portion of their assets, which provide a number of benefits to the insurer and their policyholders. Those benefits include:

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NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To:	Cassie Brown, Commissioner, Life Actuarial (A) Task Force Chair and
	Scott A. White, Commissioner, Life Actuarial (A) Task Force Vice Chair
From:	Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and
	Justin Schrader, Macroprudential (E) Working Group Chair
CC:	NAIC Support Staff: Reggie Mazyck/Jennifer Frasier
Date:	July 21, 2022
Re:	Referral from the Plan for the List of MWG Considerations

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MWG Consideration Items Referred:

(Consideration 4 has been referred to the Risk-Focused Surveillance (E) Working Group. A copy follows since the Life Actuarial (A) Task Force is already performing work related to this consideration.)

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.
    a. *Life Actuarial (A) Task Force (LATF) work addresses this – helping to ensure the long-term life liabilities (reserves) and future fees to be paid out of the insurer are supported by appropriately modeled assets.*

Regulator discussion results:
- *In addition to LATF's work*, refer this item to the NAIC Risk-Focused Surveillance (E) Working Group, as it is already looking at some of this work related to affiliated agreements and fees. Items discussed:
    - Capital maintenance agreements, suggesting guidance for the appropriate entities to provide them and considering ways to make them stronger.

(Similarly, Consideration 10 has been referred to the Examination Oversight (E) Task Force. A copy follows because of LATF's existing work related to this item.)

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. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
    a. *LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.*

b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

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- Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency."

- ♣ While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
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    - The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.
- ♣ A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

AIC Comment on "Privately Structured Securities" (the comment and its 6 bullets follow) – Regulators asked the AIC to follow the work of the NAIC Examination Oversight (E) Task Force and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.

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(Similarly, Consideration 12.a. has been referred to the Statutory Accounting Principles (E) Working Group. A copy follows because of LATF's existing work related to this item.)

12. The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above. (Enhanced reporting in 2021 Separate Accounts blank will specifically identify assets backing PRT liabilities.) Considerations have also been raised regarding the RBC treatment of PRT business.
    a. **LATF has exposed an Actuarial Guideline** to achieve a primary goal of ensuring claims-paying ability even if the complex assets (often private equity-related) did not perform as the company expects, and a secondary goal to require stress testing and best practices related to valuation of non-publicly traded assets (note – LATF's considerations are not limited to PRT). Comment period for the 2nd exposure draft ends on May 2.

       Regulator discussion results:

- Regulators focused on the need to have disclosures on the risks to the General Account from the Separate Account PRT business – for guarantees but also reporting/tracking when the Separate Account is not able to support its own liabilities. Regulators noted the need to address the differences between buy in PRT transactions and buy out.
- *Regulators are comfortable LATF is addressing the reserve considerations*. To address the disclosure considerations, regulators support sending a referral to the Statutory Accounting Principles (E) Working Group since regulators suggested it be an item in the Notes to Financial Statements. (Regulators noted it might help to discuss such disclosure concepts with LATF's Valuation Manual 22 (A) Working Group.)
    - While the exposed AG is not limited to PRT, and general disclosures may be helpful, regulators recognized additional and/or more specific disclosures may be needed for PRT business.

(The MWG regulators deferred specifying action on this item. A copy follows because of LATF's existing work related to this item.)

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.
    a. *LATF's exposed AG was modified to require the company to provide commentary on reinsurance collectability and counterparty risk in the asset adequacy analysis memorandum. The original concept of requiring life insurers to model the business itself even if it uses these mechanisms to share/transfer risk was deferred to allow time to consider and address concerns over potential violations with EU/UK covered agreements and the 2019 revisions to NAIC Models 785 and 786.*

Regulator discussion results:
- Regulators held candid conversations about the need to understand why insurers are using these types of offshore reinsurers. If there are problems in the U.S. regulatory system that are driving insurers to utilize offshore reinsurers (e.g., "excess" reserves), we should know of those problems so we can consider if there are appropriate changes to make.
- If there are other drivers, per the common theme in the regulators' review of this list of considerations, there isn't a presumption that the use of these transactions is categorically bad. Rather, there is a need to understand the economic realities of the transactions so the regulators can effectively perform their solvency monitoring responsibilities.
    - Regulators discussed the potential concept of additional Holding Company Act requirements if these are affiliated reinsurers, disclosing the insurer benefits (reserves, capital, etc.).
- Regulators deferred specifying action on this item at this time, instead noting the desire to have meetings with industry representatives using these transactions and regulators from some of the offshore jurisdictions to gain more insights.

Northwestern Mutual Comment (2 cautions) – These cautions will be included as part of the MWG's future discussions and work for this Consideration.
- Caution: Reinsurance transactions can and often do serve a valuable function by reallocating risk. However, offshore reinsurance can also result in lower total reserves and

capital, reduced state regulatory oversight, and diminished stakeholder transparency from what would be required by the statutory accounting and risk-based capital requirements the NAIC has established to protect policyholders in the United States.

- Caution: Without progress and action on the item pertaining to offshore reinsurance, the Working Group's progress on other MWG Considerations could further incentivize even more utilization of offshore reinsurance transactions and undercut the NAIC's efforts to close other solvency regulatory gaps domestically. In the long run, a system that encourages companies to transfer business to a related offshore entity in order to alter their reserves and capital from uniform standards diminishes the strength of reserve and capital regulation in the United States. If capital standards are deemed to be too conservative in the US, they should be addressed transparently and uniformly through the NAIC and not through the alternate means of offshore reinsurance.

To: Amy L. Beard, Commissioner, Examination Oversight (E) Task Force Chair and

Karima M. Woods, Commissioner, Examination Oversight (E) Task Force Vice Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Bailey Henning

Date: August 1, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

The Financial Condition E Committee adopted this plan with no changes made during its virtual meeting on July 21, 2022. NAIC staff support drafted this referral letter to accomplish the actions captured in the adopted plan. It is unlikely any further modifications will occur to the adopted plan when it is considered for adoption by the full Plenary, but it is a possibility. Please begin work to address these referrals, recognizing the adoption by Plenary is still outstanding.

Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these

discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

8. Though the 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.
    a. An agenda item and blanks proposal are being re-exposed by SAPWG. The concept being used for investment schedule disclosures is the use of code indicators to identify the role of the related party in the investment, e.g., a code to identify direct credit exposure as well as codes for relationships in securitizations or similar investments.

Regulator discussion results:

- Like the previous consideration, regulators are looking forward to using these code disclosures to help target areas for further review. However, specific to CLO/structured security considerations, regulators support a referral to the Examination Oversight (E) Task Force. Specific items discussed include:
    - Since investors in CLOs obtain monthly collateral reports, regulators should consider asking for such reports when concerns exist regarding a company's potential exposure to affiliated entities within their CLO holdings.
    - Regulators would like to have more information regarding the underlying portfolio companies affiliated with a CLO manager to help quantify potential exposure between affiliates and related parties.
    - Regulators request NAIC staff to consider their ability to provide tools and/or reports to help regulators target CLOs/structured securities to consider more closely.

RRC Comments on "collateralized loan obligations (CLOs) as a source of concern and therefore a focus for additional disclosure. "While there has been a continuing level of concern about CLOs in general, RRC encourages the working group to take a broader view as well. As a general matter, investments in CLOs are at least subject to disclosure and conflicts of interest standards under various securities laws and regulations. On the other hand, there are other potentially problematic investments that do not benefit from that regulatory oversight.

- ♣ Private funds – Some of the issues noted with respect to concerns about overlapping interests in CLOs may also be prevalent in various kinds of funds, especially privately placed funds that are reported on Schedule BA. Such investment vehicles may have significant areas that have the potential for a conflict of interest that would not be captured by securities laws. Such investment vehicles may also include substantial management fees for management of the fund.

- ♣ Collateral Loans – The U.S. insurance industry's reported exposure to Collateral Loans that are reported on Schedule BA has grown substantially in the last ten years. In addition to the same potential conflicts, it may be appropriate to revisit valuation and reporting guidance.

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. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
    a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
    b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. They agreed to wait for any further work or referral until they have an opportunity to work with the results of the VOSTF proposal and the SAPWG Schedule D revamp project.
- Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency."

- While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
  - Any highly structured transaction is going to lack liquidity.
  - The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.
- A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

AIC Comment on "Privately Structured Securities" (the comment and its 6 bullets follow) – *Regulators asked the AIC to follow the work of the NAIC Examination Oversight (E) Task Force* and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.

Insurers are increasingly seeking the services of alternative asset managers with significant asset origination capabilities and private credit expertise to manage a portion of their assets, which provide a number of benefits to the insurer and their policyholders. Those benefits include:

- A natural alignment between the long-dated insurance liabilities and the long-term investment approach taken by alternative asset managers, including in the private credit space;
- Alternative asset managers have the ability to source, underwrite and execute private credit transactions that require skill sets, experience, and scale that many insurance companies do not possess in-house;
- Private equity and private credit firms also provide an opportunity for smaller and midsized insurers to access these asset classes, which historically have been the primary purview of large insurers that have the scale to afford in-house asset management functions that can originate these assets, making the industry more competitive to the ultimate benefit of policyholders;
- Engaging asset managers with differentiated capabilities can be more cost efficient than making significant investments in an internal asset management function. By availing themselves of these advantages, insurers can benefit from cost-effective sourcing and origination capabilities in attractive asset classes, resulting in enhanced long-term adequacy margins for policyholders, increased spread/earnings, and more competitive product pricing that inures to the benefit of policyholders;
- Asset-backed security default rates are substantially similar to corporate investment grade debt default rates while CLO default rates are substantially lower than corporate default rates; and

- The focus on private investments is belied by the fact that institutions with higher allocations to private investments have outperformed (with less volatility) those with less.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To: Justin Schrader, Group Solvency Issues (E) Working Group Chair and

Jamie Walker, Group Solvency Issues (E) Working Group Vice Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Bruce Jenson/Ramon Calderon

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

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Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these

discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

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MWG Consideration Items Referred:

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).

   Regulator discussion results:
   - Refer this item to the NAIC Group Solvency Issues (E) Working Group. Items discussed:
     - Instead of requiring for all Form A acquisitions to provide additional disclosures, structure an optional disclosure requirement that can be used when unresolved regulatory concerns exist with the acquisition. For example:
       - Disclosures to allow regulators to assess the goal of the potential owner in acquiring the insurer, how the potential owner will be paid and in what amounts, and the ability of the potential owner to provide capital support as needed.
       - Copies of disclosures provided to the potential owner's investors.
     - Provide training as needed to states with less experience reviewing complex Form A transactions and refer those states to more experienced states for live help.
       - These options include highlighting the need to use external expertise for complex transactions, especially to understand non-U.S. affiliations and when assessing multiple complex Form A applications, and at the expense of the Form A applicant.

   American Investment Council (AIC) Comment (recommended 2 items) – These two items will be included in the referral to the NAIC Group Solvency Issues (E) Working Group for its work on Consideration #1.
   - Recommendation: The Working Group should assess, among other items: (i) the need to provide regulatory certainty *vis a vis* when and on what basis additional disclosures could be required; and (ii) whether the additional disclosures would extend approval timelines. We believe such items are critical to insurers being able to access the capital markets effectively and efficiently.

2. Control is presumed to exist where ownership is >=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.

Regulator discussion results:

- Refer this item to the NAIC Group Solvency Issues (E) Working Group. Regulators recognized the integral connection of the first two considerations. Items discussed:
    - An emphasis on training and providing detailed examples to address the complexity and creativity involved in some of these Form A agreements and holding company structures.
    - It is not practical to get copies of operating agreements from every entity in a group to assess control impacts to the insurers. Consider ways of better targeting the pertinent agreements to assess, including a potential list of questions about less than 10% owners for use when considering Form A applications and/or ongoing analysis.
    - Consider if Form B (Insurance Holding Company System Annual Registration Statement) disclosure requirements should be modified to address these considerations.

AIC Comment (2 primary concerns) – Regulators asked the AIC to follow the work of the NAIC Group Solvency Issues (E) Working Group on Consideration #2 and make comments on specific recommendations if needed.

- Concerns: 1) The 10% presumption of control needs to remain; and 2) contractual terms contained in service agreements that are negotiated on an arm's length basis are not sufficient to convey the power to direct or cause the direction of an insurer, so long as they are subject to the ultimate supervision and control by the insurer through general oversight of the service provider and other customary contractual provisions.

For Considerations 1 and 2 above:

Risk & Regulatory Consulting (RRC) Comment: In a Form A transaction, whether the owner of the insurer is a PE fund or another type of investor, expectations and structures behind insurer ownership may have changed. Because of that, RRC believes that the stipulations, either limited time or continuing, should protect against adverse policyholder outcomes resulting from that change in dynamic.

- ♣ The regulatory expectation is that owners of insurers should have a long, if not indefinite, time horizon. It is not uncommon for PE funds in general and other similar investment vehicles to have a limited time frame because they are specifically structured investment vehicles such as limited partnerships. For example, requiring that limited partnerships should not have a specific end date would bring that ownership vehicle into line with regulatory expectations.
- ♣ While there are typically no guarantees of additional funding in any ownership situation, having a structure that allows for backstop capital in the event that a need arises should be considered. This could be achieved through a parental guarantee or a capital maintenance agreement.

- With regards to dividends, even if dividends are permitted, it may be advisable to Memo 2 structure a claw back period. This could be effectuated with allowing dividends to the limited partnership structure but requiring that the funds not be paid out to the partners for some period of time to ensure that the availability is not short-lived.
- In a limited partnership structure, the limited partners may be considered passive investors and arguably should not be subject to the typical expectations of owners. However, additional understanding and restrictions on the interest of the general partner would be appropriate.
- In the event that the Form A includes transfer of business to offshore entities, requiring continued maintenance of capital levels similar to those in place prior to the transaction, and ongoing reporting to the U.S. regulator that is in line with the Statutory reporting framework, to ensure that there are no adverse implications to policyholders.
- Ensuring that corporate governance appropriately balances the desire for strong returns with the need to protect policyholders. For example, the Board and senior management should include members with appropriate background and knowledge of insurance laws and operations. In addition, risk and compliance functions should have appropriate reporting and communication lines to the Board.
- Policyholder non-guaranteed elements, such as credited rates and dividends, should not be inappropriately reduced from existing levels.

NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To:	Amy Malm, Risk-Focused Surveillance (E) Working Group Chair and
	Justin Schrader, Risk-Focused Surveillance (E) Working Group Vice Chair
From:	Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and
	Justin Schrader, Macroprudential (E) Working Group Chair
CC:	NAIC Support Staff: Bruce Jenson/Jane Koenigsman
Date:	July 21, 2022
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MWG Consideration Items Referred:

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.

Regulator discussion results:

- Refer this item to the NAIC Risk-Focused Surveillance (E) Working Group. Regulators recognized similar dynamics to the first two considerations, but this Working Group was selected because it is already currently focused on a project involving affiliated agreements and Form D filings. Items discussed:
    - Consider training and examples, such as unique termination clauses and use of sub-advisors with the potential for additive fees, and strategies to address these.
        - This included addressing pushback on obtaining sub-advisor agreements as Form D disclosures and some optional disclosures for the Form A.
    - Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?
    - Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate; follow any Statutory Accounting Principles (E) Working Group projects related to this topic and provide comments needed.

Risk & Regulatory Consulting (RRC) Comment: "With respect to an Investment Management Agreement, RRC encourages an approach that includes a thorough review of the IMA to ensure it is fair and reasonable to the insurer. In addition to the specific items noted for consideration:

- ♣ Are there detailed and reasonable investment guidelines?
- ♣ Is there sufficient expertise at the insurer and on the insurer's Board to properly assess the performance and compliance of the investment manager?
- ♣ Is the investment manager registered as such under the Investment Advisers Act of 1940, and recognizes the standard of care as a fiduciary?

AIC Comments on "Conflict of Interest, Fees, and Termination" (3 individual comments):

Conflict of Interest

As a general matter, the terms of a contractual agreement should not be viewed as giving rise to a conflict of interest when the agreement is negotiated on an arm's length basis. Notwithstanding the foregoing, current law provides an established process to address potential conflicts (for example, requirements to appoint independent directors and traditional corporate law processes to ensure fairness and, under certain circumstances, review of transactions by regulators pursuant to Form D filings). Accordingly, investments sourced and allocated by alternative asset managers on behalf of insurance company clients should not, absent other factors, be viewed as presenting a potential conflict of interest, particularly where insurers retain full control over asset allocation (for example, insurers retain control over the asset classes in which they invest, as well as the amounts and periods of time over which such asset exposure is achieved).

Fees

Importantly, as an initial consideration, any fees paid to investment managers cannot be considered in isolation, rather they should be considered on a "net" basis – i.e., on the basis of total return (after fees are taken into account). Sophisticated institutional investors (including insurers) have a successful history of investing in a range of strategies despite certain investment products generally having higher fees than other available investment opportunities. On a net basis, private equity has consistently outperformed more traditional asset classes such as publicly traded stocks and public mutual funds8 Net-of-fees private debt funds have also consistently outperformed bond and equity market benchmarks.9 Insurers continue to recognize the value of investment opportunities that outperform when considered on a net basis.10 This approach has enabled the consistent delivery of industry leading investment results, which ultimately leads to a high level of financial strength.

Termination

Asset managers often dedicate extensive resources at the outset of a new arrangement in support of managing an insurer's general account assets (e.g., dedicating or reassigning existing personnel, hiring new employees, investing in information technology systems, expanding office space, further enhancing compliance and regulatory processes). As such, and because, in our experience, insurers have the right to terminate their investment management agreements (e.g., upon 30 days' notice), the desire for external asset managers to seek contractual protections (subject to arms' length negotiations) should an insurer decide to terminate the arrangement earlier than was originally anticipated by the parties is entirely appropriate.

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.

a. Life Actuarial (A) Task Force (LATF) work addresses this – helping to ensure the long-term life liabilities (reserves) and future fees to be paid out of the insurer are supported by appropriately modeled assets.

Regulator discussion results:

- In addition to LATF's work, refer this item to the NAIC Risk-Focused Surveillance (E) Working Group, as it is already looking at some of this work related to affiliated agreements and fees. Items discussed:
    - Capital maintenance agreements, suggesting guidance for the appropriate entities to provide them and considering ways to make them stronger.

For Considerations 3 and 4 above (and for the FYI Consideration 5 below):

RRC Comment: In a Form A transaction, whether the owner of the insurer is a PE fund or another type of investor, expectations and structures behind insurer ownership may have changed. Because of that, RRC believes that the stipulations, either limited time or continuing, should protect against adverse policyholder outcomes resulting from that change in dynamic.

- ♣ The regulatory expectation is that owners of insurers should have a long, if not indefinite, time horizon. It is not uncommon for PE funds in general and other similar investment vehicles to have a limited time frame because they are specifically structured investment vehicles such as limited partnerships. For example, requiring that limited partnerships should not have a specific end date would bring that ownership vehicle into line with regulatory expectations.
- ♣ While there are typically no guarantees of additional funding in any ownership situation, having a structure that allows for backstop capital in the event that a need arises should be considered. This could be achieved through a parental guarantee or a capital maintenance agreement.
- ♣ With regards to dividends, even if dividends are permitted, it may be advisable to Memo 2 structure a claw back period. This could be effectuated with allowing dividends to the limited partnership structure but requiring that the funds not be paid out to the partners for some period of time to ensure that the availability is not short-lived.
- ♣ In a limited partnership structure, the limited partners may be considered passive investors and arguably should not be subject to the typical expectations of owners. However, additional understanding and restrictions on the interest of the general partner would be appropriate.
- ♣ In the event that the Form A includes transfer of business to offshore entities, requiring continued maintenance of capital levels similar to those in place prior to the transaction, and ongoing reporting to the U.S. regulator that is in line with the Statutory reporting framework, to ensure that there are no adverse implications to policyholders.
- ♣ Ensuring that corporate governance appropriately balances the desire for strong returns with the need to protect policyholders. For example, the Board and senior management should include members with appropriate background and knowledge of insurance laws and operations. In addition, risk and compliance functions should have appropriate reporting and communication lines to the Board.

- ♣ Policyholder non-guaranteed elements, such as credited rates and dividends, should not be inappropriately reduced from existing levels.

<u>The following MWG Considerations were not referred to the Risk-Focused Surveillance (E) Working Group, but the regulator discussions either considered such a referral or mentioned work already underway at and/or assigned to the Risk-Focused Surveillance (E) Working Group in the above referrals</u>.

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 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.
   a. The NAIC Financial Analysis Handbook includes guidance specific to Form A consideration and post approval analysis processes regarding PE owners of insurers (developed previously by the Private Equity Issues (E) Working Group).

   <u>Regulator discussion results</u>:
   - Regulators <u>considered</u> referring this consideration to the NAIC Risk-Focused Surveillance (E) Working Group but opted to keep developing more specific suggestions for now. Items discussed:
     - Consider optional Form A disclosures and guidance for less experienced states; review EU conduct of business language and consider if similar concepts would help target the optional use.
     - Consider more detailed guidance for financial examinations.
     - Besides just inexperience, the consideration also includes intentional actions that ignore known concerns to achieve owner's results; might need to consider Market Conduct group(s).

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 CLO which is managed or structured by a related party.
   a. An agenda item and blanks proposal are being re-exposed by SAPWG. Desire for 2022 year-end reporting to include disclosures identifying related-party issuance/acquisition.

   <u>Regulator discussion results</u>:
   - Regulators are comfortable the SAPWG's work is sufficient as a first step since it involves code disclosures to identify various related party issues. *They also recognize that <u>existing and/or referred work</u> at the Risk-Focused Surveillance (E) Working Group may address some items in this consideration*. Once regulators work with these SAPWG disclosures and

other regulatory enhancement, further regulatory guidance may be considered as needed.)

9. Broader considerations exist around asset manager affiliates (not just PE owners) and disclaimers of affiliation avoiding current affiliate investment disclosures. A new Schedule Y, Pt 3, has been adopted and is in effect for year-end 2021. This schedule will identify all entities with greater than 10% ownership – regardless of any disclaimer of affiliation - and whether there is a disclaimer of control/disclaimer of affiliation. It will also identify the ultimate controlling party.
    a. Additionally, SAPWG is developing a proposal to revamp Schedule D reporting, with primary concepts to use principles to determine what reflects a qualifying bond and to identify different types of investments more clearly. For example, D1 may include issuer credits and traditional ABS, while a sub-schedule of D1 could be used for additional disclosures for equity-based issues, balloon payment issues, etc. This is a much longer-term project, 2024 or beyond.

Regulator discussion results:

- Regulators recognize the new Schedule Y, Part 3, will give them more insights for owners of greater than 10%, but it does not provide insights for owners of less than 10%. *However, regulators also recognize that existing and/or referral work of the Risk-Focused Surveillance (E) Working Group may help with some of this dynamic*. Additionally, since the SAPWG 2022 code project and its longer-term Schedule D revamp project will help provide further disclosures that will assist with this consideration, regulators are comfortable waiting to see if further regulatory guidance is needed after using the resulting disclosures and other enhancements from these projects.
    - Specific to owners of less than 10%, regulators discussed the April 19, 2022, Insurance Circular Letter No. 5 (2022) sent by the New York Department of Financial Services to all New York domiciled insurers and other interested parties. This letter highlights that avoiding the levels deemed presumption of control, e.g., greater than 10% ownership, does not create a safe harbor from a control determination and the related regulatory requirements. The circular letter was distributed to all MWG members and interested regulators.

As an FYI for Considerations 7 and 9 above:

RRC Comments on "collateralized loan obligations (CLOs) as a source of concern and therefore a focus for additional disclosure. "While there has been a continuing level of concern about CLOs in general, RRC encourages the working group to take a broader view as well. As a general matter, investments in CLOs are at least subject to disclosure and conflicts of interest standards under various securities laws and regulations. On the other hand, there are other potentially problematic investments that do not benefit from that regulatory oversight.

- ♣ Private funds – Some of the issues noted with respect to concerns about overlapping interests in CLOs may also be prevalent in various kinds of funds, especially privately placed funds that are reported on Schedule BA. Such investment vehicles may have significant areas that have the potential for a conflict of interest that would not be captured by securities laws. Such investment vehicles may also include substantial management fees for management of the fund.

- Collateral Loans – The U.S. insurance industry's reported exposure to Collateral Loans that are reported on Schedule BA has grown substantially in the last ten years. In addition to the same potential conflicts, it may be appropriate to revisit valuation and reporting guidance.

Seong-min Eom, Longevity Risk (E/A) Subgroup Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Dave Fleming/Reggie Mazyck

Date: July 21, 2022

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NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

(The following MWG Consideration was not referred to the Life RBC (E) Working Group. Consideration 12.d. has been included here because of the MWG regulators' reference to the LRT Subgroup's work.)

12. The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above. (Enhanced reporting in 2021 Separate Accounts blank will specifically identify assets backing PRT liabilities.) Considerations have also been raised regarding the RBC treatment of PRT business.

    d. "Considerations have also been raised regarding the RBC treatment of PRT business."
    Regulator discussion results:
    - Regulators recognized the work of the *Longevity Risk Transfer (LRT) Subgroup of the Life Risk-Based Capital (E) Working Group and Life Actuarial (A) Task Force* covers PRT business. A new LRT charge was included in the 2021 Life Risk-Based Capital (LRBC) formula. Regulators agreed the results of this new charge should be monitored.
    - While regulators agreed to follow the work of the LRT Subgroup, they suggested no further action at this time.

NAIC NATIONAL ASSOCIATION OF INSURANCE COMMISSIONERS

To: Dale Bruggeman, Statutory Accounting Principles (E) Working Group Chair,

Kevin Clark, Statutory Accounting Principles (E) Working Group Co-Vice Chair, and

Carrie Mears, Statutory Accounting Principles (E) Working Group Co-Vice Chair

From: Marlene Caride, Commissioner, Financial Stability (E) Task Force Chair and

Justin Schrader, Macroprudential (E) Working Group Chair

CC: NAIC Support Staff: Julie Gann/Robin Marcotte/Jim Pinegar/Jake Stultz/Jason Farr

Date: July 21, 2022

Re: Referral from the Plan for the List of MWG Considerations

The NAIC Macroprudential (E) Working Group (MWG) of the Financial Stability (E) Task Force (FSTF) was charged with coordinating the various NAIC activities related to private equity (PE) owned insurers. As an initial step, the MWG developed a list of 13 regulatory considerations. These considerations are frequently referenced as private equity (PE) concerns, but the Working Group developed the list with an activities-based frame of mind, recognizing that any ownership type and/or corporate structure could participate in these activities, including but not limited to PE owned insurers. The MWG members discussed detailed elements of the considerations and potential regulatory work, including explicit reference to the 2013 guidance added to the NAIC Financial Analysis Handbook for Form A reviews when a private equity owner was involved, and interested parties added useful comments to these during an exposure period. The MWG and FSTF adopted a final plan for addressing each of the 13 considerations, including many referrals to other NAIC committee groups.

The Financial Condition E Committee adopted this plan with no changes made during its virtual meeting on July 21, 2022. NAIC staff support drafted this referral letter to accomplish the actions captured in the adopted plan. It is unlikely any further modifications will occur to the adopted plan when it is considered for adoption by the full Plenary, but it is a possibility. Please begin work to address these referrals, recognizing the adoption by Plenary is still outstanding.

Each MWG consideration referred to your group is listed below. The summarized notes from the MWG regulator-only discussions follow the consideration in blue font and any interested party comments are also provided in purple font. Please consider these

discussion points and comments in addition to your own discussion ideas when developing proposals to address the MWG consideration.

NAIC staff support for the MWG will follow the work your group performs and summarize your activities for reporting up to the FSTF. If you have any questions or need further direction, please contact Todd Sells (tsells@naic.org).

MWG Consideration Items Referred:

12. The trend of life insurers in pension risk transfer (PRT) business and supporting such business with the more complex investments outlined above. (Enhanced reporting in 2021 Separate Accounts blank will specifically identify assets backing PRT liabilities.) Considerations have also been raised regarding the RBC treatment of PRT business.
    a. **LATF has exposed an Actuarial Guideline** to achieve a primary goal of ensuring claims-paying ability even if the complex assets (often private equity-related) did not perform as the company expects, and a secondary goal to require stress testing and best practices related to valuation of non-publicly traded assets (note – LATF's considerations are not limited to PRT). Comment period for the 2nd exposure draft ends on May 2.

       Regulator discussion results:
       - Regulators focused on the need to have disclosures on the risks to the General Account from the Separate Account PRT business – for guarantees but also reporting/tracking when the Separate Account is not able to support its own liabilities. Regulators noted the need to address the differences between buy in PRT transactions and buy out.
       - Regulators are comfortable LATF is addressing the reserve considerations. *To address the disclosure considerations, regulators support sending a referral to the Statutory Accounting Principles (E) Working Group since regulators suggested it be an item in the Notes to Financial Statements.* (Regulators noted it might help to discuss such disclosure concepts with LATF's Valuation Manual 22 (A) Working Group.)
           - While the exposed AG is not limited to PRT, and general disclosures may be helpful, regulators recognized additional and/or more specific disclosures may be needed for PRT business.

(Consideration 3 has been referred to the Risk-Focused Surveillance (E) Working Group. A copy follows since the Statutory Accounting Principles (E) Working Group (SAPWG) is referenced in the regulator discussion.)

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.

Regulator discussion results:

- Refer this item to the NAIC Risk-Focused Surveillance (E) Working Group. Regulators recognized similar dynamics to the first two considerations, but this Working Group was selected because it is already currently focused on a project involving affiliated agreements and Form D filings. Items discussed:
    - Consider training and examples, such as unique termination clauses and use of sub-advisors with the potential for additive fees, and strategies to address these.
        - This included addressing pushback on obtaining sub-advisor agreements as Form D disclosures and some optional disclosures for the Form A.
    - Given the increasing prevalence of bespoke agreements, does it make sense to tie this work in to the work of the NAIC Valuation of Securities (E) Task Force and/or the NAIC Securities Valuation Office? If yes, how best to do so?
    - Surplus Notes and appropriate interest rates given their special regulatory treatment, including whether floating rates are appropriate; *follow any Statutory Accounting Principles (E) Working Group projects related to this topic and provide comments needed*.

Risk & Regulatory Consulting (RRC) Comment: "With respect to an Investment Management Agreement, RRC encourages an approach that includes a thorough review of the IMA to ensure it is fair and reasonable to the insurer. In addition to the specific items noted for consideration:

- Are there detailed and reasonable investment guidelines?
- Is there sufficient expertise at the insurer and on the insurer's Board to properly assess the performance and compliance of the investment manager?
- Is the investment manager registered as such under the Investment Advisers Act of 1940, and recognizes the standard of care as a fiduciary?

AIC Comments on "Conflict of Interest, Fees, and Termination" (3 individual comments):

Conflict of Interest

As a general matter, the terms of a contractual agreement should not be viewed as giving rise to a conflict of interest when the agreement is negotiated on an arm's length basis. Notwithstanding the foregoing, current law provides an established process to address potential conflicts (for example, requirements to appoint independent directors and traditional corporate law processes to ensure fairness and, under certain circumstances, review of transactions by regulators pursuant to Form D filings). Accordingly, investments sourced and allocated by alternative asset managers on behalf of insurance company clients should not, absent other factors, be viewed as presenting a potential conflict of interest, particularly where insurers retain full control over asset allocation (for example, insurers retain control over the asset classes in which they invest, as well as the amounts and periods of time over which such asset exposure is achieved).

Fees

Importantly, as an initial consideration, any fees paid to investment managers cannot be considered in isolation, rather they should be considered on a "net" basis – i.e., on the basis of total return (after fees are taken into account). Sophisticated institutional investors (including insurers) have a successful history of investing in a range of strategies despite certain investment products generally having higher fees than other available investment opportunities. On a net basis, private equity has consistently outperformed more traditional asset classes such as publicly traded stocks and public mutual funds8 Net-of-fees private debt funds have also consistently outperformed bond and equity market benchmarks.9 Insurers continue to recognize the value of investment opportunities that outperform when considered on a net basis.10 This approach has enabled the consistent delivery of industry leading investment results, which ultimately leads to a high level of financial strength.

Termination

Asset managers often dedicate extensive resources at the outset of a new arrangement in support of managing an insurer's general account assets (e.g., dedicating or reassigning existing personnel, hiring new employees, investing in information technology systems, expanding office space, further enhancing compliance and regulatory processes). As such, and because, in our experience, insurers have the right to terminate their investment management agreements (e.g., upon 30 days' notice), the desire for external asset managers to seek contractual protections (subject to arms' length negotiations) should an insurer decide to terminate the arrangement earlier than was originally anticipated by the parties is entirely appropriate.

(Similarly, Considerations 7, 8 and 9 are included because of reference to SAPWG work related to these considerations and the MWG regulators' decision to forward an RRC comment to the SAPWG due to its work related to these three considerations.)

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 CLO which is managed or structured by a related party.
    a. *An agenda item and blanks proposal are being re-exposed by SAPWG*. Desire for 2022 year-end reporting to include disclosures identifying related-party issuance/acquisition.

Regulator discussion results:

- Regulators are comfortable the SAPWG's work is sufficient as a first step since it involves code disclosures to identify various related party issues. They also recognize that existing and/or referred work at the Risk-Focused Surveillance (E) Working Group may address some items in this consideration. *Once regulators work with these SAPWG disclosures* and other regulatory enhancement, further regulatory guidance may be considered as needed.)

8. Though the 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.

a. *An agenda item and blanks proposal are being re-exposed by SAPWG*. The concept being used for investment schedule disclosures is the use of code indicators to identify the role of the related party in the investment, e.g., a code to identify direct credit exposure as well as codes for relationships in securitizations or similar investments.

Regulator discussion results:

- Like the previous consideration, regulators are looking forward to using these code disclosures to help target areas for further review. However, specific to CLO/structured security considerations, regulators support a referral to the Examination Oversight (E) Task Force. Specific items discussed include:
  - Since investors in CLOs obtain monthly collateral reports, regulators should consider asking for such reports when concerns exist regarding a company's potential exposure to affiliated entities within their CLO holdings.
  - Regulators would like to have more information regarding the underlying portfolio companies affiliated with a CLO manager to help quantify potential exposure between affiliates and related parties.
  - Regulators request NAIC staff to consider their ability to provide tools and/or reports to help regulators target CLOs/structured securities to consider more closely.

RRC Comments on "collateralized loan obligations (CLOs) as a source of concern and therefore a focus for additional disclosure. "While there has been a continuing level of concern about CLOs in general, RRC encourages the working group to take a broader view as well. As a general matter, investments in CLOs are at least subject to disclosure and conflicts of interest standards under various securities laws and regulations. On the other hand, there are other potentially problematic investments that do not benefit from that regulatory oversight.

- Private funds – Some of the issues noted with respect to concerns about overlapping interests in CLOs may also be prevalent in various kinds of funds, especially privately placed funds that are reported on Schedule BA. Such investment vehicles may have significant areas that have the potential for a conflict of interest that would not be captured by securities laws. Such investment vehicles may also include substantial management fees for management of the fund.
- Collateral Loans – The U.S. insurance industry's reported exposure to Collateral Loans that are reported on Schedule BA has grown substantially in the last ten years. In addition to the same potential conflicts, it may be appropriate to revisit valuation and reporting guidance.

9. Broader considerations exist around asset manager affiliates (not just PE owners) and disclaimers of affiliation avoiding current affiliate investment disclosures. A new Schedule Y, Pt 3, has been adopted and is in effect for year-end 2021. This schedule will identify all entities with greater than 10% ownership – regardless of any disclaimer of affiliation - and whether there is a disclaimer of control/disclaimer of affiliation. It will also identify the ultimate controlling party.

a. Additionally, *SAPWG is developing a proposal to revamp Schedule D reporting*, with primary concepts to use principles to determine what reflects a qualifying bond and to identify different types of investments more clearly. For example, D1 may include issuer credits and traditional ABS, while a sub-schedule of D1 could be used for additional disclosures for equity-based issues, balloon payment issues, etc. This is a much longer-term project, 2024 or beyond.

Regulator discussion results:

- Regulators recognize the new Schedule Y, Part 3, will give them more insights for owners of greater than 10%, but it does not provide insights for owners of less than 10%. *However, regulators also recognize that existing and/or referral work of the Risk-Focused Surveillance (E) Working Group may help with some of this dynamic*. Additionally, since the SAPWG 2022 code project and its longer-term Schedule D revamp project will help provide further disclosures that will assist with this consideration, regulators are comfortable waiting to see if further regulatory guidance is needed after using the resulting disclosures and other enhancements from these projects.
    - Specific to owners of less than 10%, regulators discussed the April 19, 2022, Insurance Circular Letter No. 5 (2022) sent by the New York Department of Financial Services to all New York domiciled insurers and other interested parties. This letter highlights that avoiding the levels deemed presumption of control, e.g., greater than 10% ownership, does not create a safe harbor from a control determination and the related regulatory requirements. The circular letter was distributed to all MWG members and interested regulators.

For Considerations 7, 8, and 9 above, the following RRC comment was directed to the SAPWG for its work related to these considerations:

RRC Comments on "collateralized loan obligations (CLOs) as a source of concern and therefore a focus for additional disclosure. "While there has been a continuing level of concern about CLOs in general, RRC encourages the working group to take a broader view as well. As a general matter, investments in CLOs are at least subject to disclosure and conflicts of interest standards under various securities laws and regulations. On the other hand, there are other potentially problematic investments that do not benefit from that regulatory oversight.

- Private funds – Some of the issues noted with respect to concerns about overlapping interests in CLOs may also be prevalent in various kinds of funds, especially privately placed funds that are reported on Schedule BA. Such investment vehicles may have significant areas that have the potential for a conflict of interest that would not be captured by securities laws. Such investment vehicles may also include substantial management fees for management of the fund.
- Collateral Loans – The U.S. insurance industry's reported exposure to Collateral Loans that are reported on Schedule BA has grown substantially in the last ten years. In addition to the same potential conflicts, it may be appropriate to revisit valuation and reporting guidance.

(For Consideration 10, referrals were made to the Examination Oversight (E) Task Force and the RBC Investment Risk and Evaluation (E) Working Group. A copy is included below due to a reference to SAPWG's Schedule D revamp project.)

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. (The NAIC Capital Markets Bureau continues to monitor this and issue regular reports, but much of the work is complex and time-intensive with a lot of manual research required. The NAIC Securities Valuation Office will begin receiving private rating rationale reports in 2022; these will offer some transparency into these private securities.)
    a. LATF's exposed AG includes disclosure requirements for these risks as well as how the insurer is modeling the risks.
    b. SVO staff have proposed to VOSTF a blanks proposal to add market data fields (e.g., market yields) for private securities. If VOSTF approves, a referral will be made to the Blanks WG.

Regulator discussion results:

- Regulators focused on the need to assess whether the risks of these investments are adequately included in insurers' results and whether the insurer has the appropriate governance and controls for these investments. Regulators discussed the potential need for analysis and examination guidance on these qualifications.
- To assist regulators in identifying concerns in these investments, regulators expressed support for the VOSTF proposal to obtain market yields to allow a comparison with the NAIC Designation. Once such data is available, regulators ask NAIC staff to develop a tool or report to automate this type of initial screening. *Also, regulators again recognized the SAPWG Schedule D revamp work will help in identifying other items for initial screening*.
- The regulators discussed LATF's exposed AG, noting the Actuarial Memorandum disclosures that would be required for these privately structured securities along with the actuarial review work, and recognizing how those would be useful for analysts and examiners when reviewing these investments. Additionally, the Valuation and Analysis (E) Working Group would be able to serve as a resource for some of these insights for states without in house actuaries.
- As a result of the above discussions, regulators agreed to a referral to the Examination Oversight (E) Task Force to address the disclosures that will be available from LATF's exposed AG. *They agreed to wait for any further work or referral until they have an opportunity to work with the results of the* VOSTF proposal and the *SAPWG Schedule D revamp project*.
- Since reserves are not intended to capture tail risk, refer this item to the NAIC RBC Investment Risk and Evaluation (E) Working Group and monitor the Working Group's progress. (Regulators adopted this recommendation from the RRC comment letter.)

RRC Comments on "privately structured securities which introduce other sources of risk or increase traditional credit risk, such as complexity risk and illiquidity risk, and involve a lack of transparency."

- ♣ While the lack of available public data does present a significant issue and does mean there is in theory a lower degree of liquidity, we caution at being overly concerned about the private nature of such transactions.
    - Any highly structured transaction is going to lack liquidity.

    - The NAIC had at one time a disclosure for Structured Notes. This allowed regulators to see when that represented an excessive risk. We encourage the reinstitution of that disclosure.
- A potential consideration related to complex asset structures would be to incorporate this risk factor into the criteria for additional liquidity risk analysis outlined in the NAIC 2021 Liquidity Stress Test Framework (Framework). Considering the amount of effort spent on developing the Framework, it may be helpful to leverage its requirements for situations in which significant complex securities are used to back insurer liabilities.

AIC Comment on "Privately Structured Securities" (the comment and its 6 bullets follow) – *Regulators asked the AIC to follow the work of the NAIC Examination Oversight (E) Task Force* and the NAIC Valuation of Securities (E) Task Force and provide comments on specific recommendations if needed.

Insurers are increasingly seeking the services of alternative asset managers with significant asset origination capabilities and private credit expertise to manage a portion of their assets, which provide a number of benefits to the insurer and their policyholders. Those benefits include:

- A natural alignment between the long-dated insurance liabilities and the long-term investment approach taken by alternative asset managers, including in the private credit space;
- Alternative asset managers have the ability to source, underwrite and execute private credit transactions that require skill sets, experience, and scale that many insurance companies do not possess in-house;
- Private equity and private credit firms also provide an opportunity for smaller and midsized insurers to access these asset classes, which historically have been the primary purview of large insurers that have the scale to afford in-house asset management functions that can originate these assets, making the industry more competitive to the ultimate benefit of policyholders;
- Engaging asset managers with differentiated capabilities can be more cost efficient than making significant investments in an internal asset management function. By availing themselves of these advantages, insurers can benefit from cost-effective sourcing and origination capabilities in attractive asset classes, resulting in enhanced long-term adequacy margins for policyholders, increased spread/earnings, and more competitive product pricing that inures to the benefit of policyholders;
- Asset-backed security default rates are substantially similar to corporate investment grade debt default rates while CLO default rates are substantially lower than corporate default rates; and
- The focus on private investments is belied by the fact that institutions with higher allocations to private investments have outperformed (with less volatility) those with less.