CLIENT ALERT

NAIC Developments on Private Equity Ownership of Insurers

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On June 27th, the NAIC's Financial Stability (E) Task Force (the "Task Force") adopted the recommendations of the Macroprudential (E) Working Group ("MWG") on the matters raised regarding the increased acquisition of life insurance companies by private equity firms. The MWG referred many of the items to other NAIC Working Groups for further analysis while noting that several ongoing work streams would address many of the concerns.

I. Background

The MWG has been developing a "List of Regulatory Considerations Applicable (But not Exclusive) to Private Equity (PE) Owned Insurers" (the "PE List") since late last year. The PE List was created in response to the NAIC Capital Markets Bureau's observation of a trend of insurer acquisitions, particularly life insurers, by private equity firms. The PE List consists of 13 regulatory considerations pertaining to the ability of state insurance regulators to effectively monitor the solvency of a legal entity insurer owned by a private equity group and to assess risks faced by the insurer's holding company system.

The MWG has been updating the PE List to reflect various statutory accounting, actuarial and valuation of securities initiatives underway at the NAIC which pertain to the regulatory considerations. Regulators have also been discussing the need for additional stipulations, disclosure requirements, and capital maintenance requirements that could be applied to owners and acquirers of insurance companies. As a result of this work, the MWG exposed an updated version of the PE

List in late April which reflects the discussion among regulators, commentary from interested parties, and proposed referrals to other working groups or task forces.

During the recent meeting, the MWG and the Task Force both voted to adopt the amended PE List. NAIC staff will now move forward with preparing referrals to the appropriate NAIC working groups and other next steps to act on the recommendations in the document. The MWG will continue to monitor the implementation of the recommendations.

II. Future Expectations

In separate conversations with regulators regarding this initiative, many emphasized the need for PE firms and insurers to be sensitive to the issues raised by the PE List and actively address them in any Form A applications. Regulators are not averse to PE firms entering the market, and indeed, believe the growth of PE firms may even be a net positive. One regulator suggested insurers be open to regular reporting on any concerns raised by regulators to ensure that regulators remain comfortable that any such concerns are being addressed.

One area of concern exposed by regulators is their lack of information and data on related-party transactions and investments. Regulators want a clearer picture of which investments are managed, structured or controlled by the investment branch of the PE firm. There is no formal requirement for insurers to identify which investments originated from a related investment manager. Consequently, regulators are working on SSAP disclosures to be added to various forms and schedules in financial statements to help identify such transactions.

Regulators have indicated they want to review affiliated or related-party transactions to ensure the fee structure is reasonable, the terms of the investment are competitive with third-party transactions, and the insurer is investing in the transaction without undue influence from the affiliated or related investment manager. There is no suggestion of widespread problems, but the lack of data and information gives rise to questions among regulators.

Clients should also be aware of the two lines of inquiry from regulators:

(1) **Appropriate RBC charges for Collateralized Loan Obligations (CLOs)**. Regulators are struggling with the appropriate RBC charge for CLOs. If the individual loans in a CLO were issued directly on an insurer's books, the resulting RBC charge would be higher than the RBC charge associated with the CLO. Regulators are looking to better understand whether the structure of the CLO makes those loans inherently less risky, or not. Regulators supported a referral to the Examination Oversight (E) Task Force for further discussion of CLOs.

(2) **Review of the increased use of offshore side cars**. Regulators are asking many of the same questions they did ten years ago on the use of and need for side cars. This time the inquiry is being driven by the rapidly growing use of offshore vehicles. The NAIC's Life Actuarial (A) Task Force is working through considerations on reinsurance collectability and counterparty risk with side cars when conducting an asset adequacy analysis. But regulators are looking

for more insight on the benefits and risks of using offshore jurisdictions, and might even reconsider the reserving practices that give rise to the excess economic capital used to support the side car. There was no formal referral of this inquiry. Rather, regulators said they want to engage in a discussion with insurers and offshore jurisdictions to gain a better understanding of the issues.

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Willkie will continue to monitor and engage with regulators on these issues. If you would like further insight, please contact anyone on our regulatory team.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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