

May 31, 2022

The Honorable Sherrod Brown
Chairman
U.S. Senate Committee on Banking, Housing, and Urban Affairs
534 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Brown:

Thank you for your interest in the growth of alternative asset management companies, private equity (PE) firms among them, in the life insurance sector, and in particular, the impact on pension risk transfers (PRT). Before delving into the insurance aspects of your inquiry, your focus on the demise of pensions and why those retirement obligations are increasingly transferred to life insurers deserves some attention and context. As Chairman of the Banking Committee, you know well the long decline of private defined benefit plans as a pillar of American retirement security. The reasons for this decline are complex but have been well documented by others and explored by Congress.

For the purposes of your inquiry however, we can use the hypothetical example of a large national employer that is in financial trouble, trending toward bankruptcy, with a large, diverse workforce depending on that employer's pension plan as the predominant source of their retirement income. Too often in this scenario, the pension plan is underfunded, managed by a company treasurer or CFO whose attention is focused on a broad array of competing corporate interests, with little expertise in assessing credit and market risk decades into the future or managing the longevity risk of a workforce spread across the country. If the company fails or if the plan is too underfunded to sustain, it can be transferred to the Pension Benefit Guaranty Corporation (PBGC) where almost certainly plan participants will see significant benefit reductions. Even if the company is in good health and the plan is well-funded, as retirees live longer, they draw benefits for longer, and if coupled with a workforce that shrinks or stagnates due to automation, globalization, or other factors, the company may recognize the unsustainable trajectory of the plan and the demands of managing it placed on its management team.

While a hypothetical, this scenario is not hard to imagine and has indeed played out across the country as defined benefit plans are now an option for just 16% of private sector employees compared to 60% just a few decades ago, according to the U.S. Bureau of Labor and Statistics. Regardless of the reasoning or rationale, when a company exits its defined benefit plan, it will

either offer a lump sum to its retirees or turn to the one sector with experience managing longevity risk: life insurers.

To be clear, we are not attempting to defend or rationalize the demise of traditional pensions, and we can certainly appreciate the apprehension of those retirees or future retirees when they see their retirement security being transferred from their employer to an insurance company they might have no relationship with. What we can say for certain, however, is that if a life insurer steps in, state regulators step up, and subject that insurer to a full suite of solvency monitoring tools and requirements to ensure that it will be there to honor those commitments, regardless of its ownership structure.

Life Insurance Regulatory Approach

Turning more specifically to insurance regulation, it is important to remember that any insurer, regardless of its ownership structure, is subject to a comprehensive regulatory regime that is experienced at both microprudential and macroprudential supervision. These existing regulatory requirements are designed explicitly to protect policyholders, refined and strengthened by lessons learned from past recessions, natural disasters, terrorist attacks, the 2008 financial crisis, and most recently the COVID-19 pandemic, all of which put our system to the test. Our system focuses on risks at the individual insurer and group level, with extensive disclosure, analysis, capital requirements, and regulatory authority to protect solvency while promoting product availability and affordability. To assist your understanding, the NAIC wishes to provide you further background information on existing requirements for all life insurers, and a bit about insurance company structures generally. A detailed description of the role of risk-based capital, reserving requirements, statutory accounting, and other regulatory safeguards are beyond the scope of your inquiry, but we are happy to discuss those in detail with you or your staff. Instead, here we will focus on certain reporting and disclosure most relevant to your inquiry about the growth of private equity ownership of insurers.

We will refer to both insurance groups and insurance legal entities – understanding how these structures work and where regulatory attention is focused is important. Typically, a large national insurer will have multiple legal entity insurers to cater to different product lines, geographic regions, or for other factors. Those legal entity insurers are typically held in a group, or holding company structure, which can include other non-insurance entities such as a broker dealer, a bank, or a non-financial entity. Only the legal entity insurers, licensed in every state they do business in, can sell or administer policies, so for this reason we enforce our risk-based capital requirements at the legal entity level, closest to the consumers, to avoid a holding company or other ownership structure moving funds away from where they are needed, particularly in times of stress.

In terms of regulatory requirements, state insurance regulators collect significant disclosures from US legal entity insurers, including some group-level disclosures. These disclosures are an important part of the state insurance regulators' solvency framework. They include significant public disclosures in the annual and quarterly statutory financial statements and supplemental filings, which detail each long-term bond owned by the insurer, the dollar amount held in that bond, along with other information on the bond such as the CUSIP, which provides individual bond characteristics. There are also many confidential holding company filings which require

disclosures of intragroup material transactions with insurers in the group. These disclosures allow state insurance regulators to monitor solvency concerns and to assess an insurer's compliance with existing state statutes and regulations, including the investment limitations that exist within those laws. These statutes include, as part of the NAIC Accreditation program, laws to govern the types and amounts of investments insurers may hold, and/or specify such investments must be prudent for the business transacted by the insurer. State insurance regulators use the investment schedule disclosures to assess the various types and amounts of bonds held by the insurer and consider the appropriateness for the insurance products written as well as to ensure they comply with state investment statutes. Other investment schedules require individual disclosures as well, such as each CUSIP of preferred stock and each real estate investment owned.

Regarding US legal entity insurers in a holding company group, a key focus of state insurance regulation is to prevent inappropriate access to insurer assets by other group legal entities, including the ultimate controlling party, and to ensure the amounts of assets are not excessive when appropriate transfers occur. The aforementioned financial filings help state insurance regulators monitor these considerations, such as making sure service agreements with the insurer(s) are arms' length transactions instead of charging excessive fees for the services.

Over the past decade, state insurance regulators have made many enhancements to group supervision, informed by lessons from the financial crisis. We've expanded and strengthened our holding company statutes, implemented stronger corporate governance requirements, and now require larger insurers to file an Own Risk and Solvency Assessment (ORSA) which is a globally recognized report of all the risks posed to an insurance group, both from within the insurers, and from non-insurance affiliates regardless of their geographic location. Additionally, we've rolled out our Group Capital Calculation, giving regulators group-wide insight into capital allocation. Indeed, some of these reforms were directly shaped by legislation you, Senator Susan Collins, and then-Senator Mike Johanns sponsored to require the Federal Reserve to tailor its own insurer capital requirements to the unique business of insurance (the so-called "Collins Amendment Fix"), setting off a collaboration that would lead to both the Fed's Building Block Approach and the NAIC's GCC reforms.

Existing NAIC data can provide some insights specifically into the concerns you raised regarding pension risk transfers acquired by life insurers. Such transfers are disclosed, so we can identify how many of the assets backing those PRT liabilities are SEC registered compared to those that are not. Our data show this for the 3 insurance groups owned by PE firms engaged in PRT business and the 29 insurance groups not affiliated with PE firms engaged in PRT business. These and other data comparisons clearly indicate differences in percentages of non-registered investments for PE owned insurers, which is a trend insurance regulators have been closely monitoring. However, shifts in asset portfolio composition tend to trickle through the broader industry over time, so we are not limiting our focus to just PE owned insurers and indeed as traditional investments have underperformed, more insurers are interested in asset backed securities, CLOs, and other investments.

Life Insurance Ownership Transactions with Private Equity Firms

With this overview of relevant regulatory practices in mind, we can turn more specifically to the growth of PE ownership of life insurers. Life insurers are long term investors who aim to match the duration of their invested assets with their liabilities, typically investing in high quality fixed income securities. Life insurers must produce enough yield from their investments to keep pace with benefits and obligations embedded in policies that can stretch out decades into the future, while not running afoul of the financial conservatism regulators expect to preserve solvency. This task has been made more challenging over the past decade due to the prolonged low interest rate environment, particularly for the very securities life insurers tend to favor, putting pressure on the whole sector regardless of ownership structure.

Life insurers have taken different approaches to mitigating this pressure, but the two main options are either raising premiums, which can put lifetime income protection out of reach for some consumers, or taking on more risk in their investment portfolios in a search for yield, which can create new pressures and regulatory scrutiny on their business. One other option is to shrink or exit from either more capital intensive or less profitable blocks of business. It is in part this reality that is driving PE and alternative asset manager interest in the sector – access to a large pool of assets that out of necessity is now taking on some additional risk in an environment when finding yield is increasingly challenging. It is important to note here that whether PE owned or not, insurance assets are still subject to the same regulatory requirements and scrutiny, so the search for yield is happening in the sector regardless of ownership structure. It is a dynamic insurance regulators have been focused on for nearly a decade since the prolonged low interest rate environment began, and one we believe we have the tools to continue addressing.

In 2013, state regulators came together through the NAIC as a result of some large, proposed acquisition of insurers by PE firms. The regulators were concerned with whether the PE firms were motivated to be long term investors and aware of the regulatory limitations and safeguards placed on insurer assets designed to protect value for policyholders, not shareholders. Due to some initial concerns with this new market dynamic, regulators for several early transactions put in place additional stipulations in order to approve these proposed transactions and the NAIC published a list of some of these stipulations as best practices when considering a change in control. Specifically, these stipulations can include:

- Requiring risk-based capital (RBC) to be maintained at a specified amount above company action level/trend test level. Because capital serves as a buffer that insurers use to absorb unexpected losses and financial shocks, this would better protect policyholders.
- Requiring quarterly RBC reports rather than annual reports as otherwise required by state law.
- Prohibiting the insurer from paying any ordinary or extraordinary dividends or other distributions to shareholders unless approved by the Commissioner.
- Requiring a capital maintenance agreement from or establishment of a prefunded trust account by the acquiring entity or appropriate holding company within the group.
- Enhancing the scrutiny of operations, dividends, investments, and reinsurance by requiring material changes in plans of operation to be filed with the commissioner (including revised

projections), which, at a minimum, would include affiliated/related party investments, dividends, or reinsurance transactions to be approved prior to such change.

- Requiring a plan to be submitted by the group that allows all affiliated agreements and affiliated investments to be reviewed, despite being below any materiality thresholds otherwise required by state law. A review of agreements between the insurer and affiliated entities may be particularly helpful to verify there are no cost-sharing agreements that are abusive to policyholder funds.
- Requiring prior Commissioner approval of material arms-length, non-affiliated reinsurance treaties or risk-sharing agreements.
- Requiring notification within 30 days of any change in directors, executive officers or managers, or individuals in similar capacities of controlling entities, and biographical affidavits and such other information as shall reasonably be required by the commissioner.
- Requiring the filing of additional information regarding the corporate structure, controlling individuals, and other operations of the company.
- Requiring the filing of any offering memoranda, private placement memoranda, any investor disclosure statements or any other investor solicitation materials that were used related to the acquisition of control or the funding of such acquisition.
- Requiring disclosure of equity holders (both economic and voting) in all intermediate holding companies from the insurance company up to the ultimate controlling person or individual but considering the burden on the acquiring party against the benefit to be received by the disclosure.
- Requiring the filing of audit reports/financial statements of each equity holder of all intermediate holding companies but considering the burden on the acquiring party against the benefit to be received by the disclosure.
- Requiring the filing of personal financial statements for each controlling person or entity of the insurance company and the intermediate holding companies up to the ultimate controlling person or company. Controlling person could include for example, a person who has a management agreement with an intermediate holding company.

Over time, as transactions were reviewed and regulators had discussions with the board and management of these firms, some of our initial concerns were reduced as PE firms either retained or brought on long-tenured insurance finance professionals and demonstrated they were in this industry for the long-term. NAIC members agreed that the additional stipulations should be included in the NAIC Financial Analysis Handbook for consideration of future PE acquisitions. The NAIC Financial Analysis Handbook is a process manual used by every state insurance regulator when performing periodic, regular analyses of insurers as well as for special purpose reviews when dealing with a group that may have a greater amount of credit, market, or liquidity risk as a result of its investment strategy.

Regulators have been paying close attention to the increase in credit, market, and liquidity risk in insurer investment strategies, as insurers try to balance risk, yield, and solvency. While there are some similarities between firms, each entity may develop its own strategy to balance these

variables, requiring regulatory tools to be adaptable. Indeed, the NAIC is actively pursuing changes to the state insurance regulators' solvency framework intended to focus on these increased risks. This includes but is not limited to potential changes in the capital requirements for certain asset backed securities such as collateralized loan obligations, changes in the asset adequacy analysis testing requirements, and a review of several risks that are more common within private equity firms but that may also be held by other insurers. This is the ongoing work to consider 13 recommendations you reference in your letter that is occurring within our Macroprudential (E) Working Group (MWG). This work will identify where existing disclosures, policies, control and affiliation requirements, and other procedures should be modified, or new ones created, to address any gaps based on the increase in the number of PE owners of insurers, the role of asset managers in insurance, and the increase of private investments in insurers' portfolios, among other reasons. We are happy to keep you apprised of this work as it proceeds, and in addition to our open meetings, minutes of our discussions are publicly available on the NAIC website.

We can turn now to your specific questions.

1. What risks do the more aggressive investment strategies pursued by private equity-controlled insurers present to policyholders?

One example of a concerning risk from the more aggressive investment strategies utilized by some private equity-controlled insurers involves owning collateralized loan obligations (CLO). CLOs consist primarily of loans to large corporations syndicated by banks. The primary underlying collateral for CLO portfolios consists most often, but not exclusively, of leveraged bank loans. Some CLOs can carry more credit or liquidity risk or have greater complexity, and as demand for CLOs has increased, there is a potential that underwriting will weaken. However, while the relative size of this asset class for the sector has been growing, it represents only 2.6% of total cash and invested assets at year-end 2020, and most of the investments held by the industry are of a higher quality. The NAIC has performed multi-scenario stress tests on industry CLO portfolios and closely monitors their performance. The NAIC Capital Markets Bureau has produced a primer on CLO investments available here: <https://content.naic.org/sites/default/files/capital-markets-primer-collateralized-loan-obligations.pdf>

This example was noted from regular, ongoing monitoring of the insurance industry. State insurance regulators review the investment strategies of all insurers regardless of type, regularly monitor their implementation of the strategies, and address concerns directly with the insurer as needed. Additionally, teams of NAIC investment experts perform regular reviews of the entire insurance industry's investments and issue reports on the status and any potential concerns. The IMF has acknowledged that the state regulatory system's access to and analysis of financial data for our sector is "world leading."

These reports sometimes highlight specific insurers for a given concern, which state insurance regulators then address directly with the insurers. Broader concerns serve as markers for states to monitor in the future actions of their regulated insurers and frequently result in NAIC committee action. For example, the NAIC has adopted specific filing requirements for investments in certain structured securities along with additional review procedures, and also adopted valuation and disclosure requirements for them as a direct result of this ongoing monitoring.

The long-term nature of typical life insurance products increases the regulatory concerns around aggressive investment strategies exposing life insurers' assets to too much potential loss. Thus, there is a heightened focus when life insurers are the subject of these monitoring activities and there are additional regulatory requirements for them. For example, life insurers must perform cash flow testing as well as asset and liability matching to demonstrate to regulators the assets held will be sufficient to cover the liabilities in the distant future. Life actuaries and financial regulators at the state of domicile review the results of these significant tests each year and address concerns directly with the life insurer. In response to changing trends in life insurance products, investment portfolio composition, or other developments, the NAIC Life Actuarial (A) Task Force (LATF) modifies the requirements and parameters for these tests as well as other actuarial requirements. LATF is currently in process of developing new actuarial guidelines to address the rise in investment complexity in life insurers' portfolios – again, with the goal of ensuring the assets will still be able to meet the liabilities in the distant future.

2. What risks do lending and other shadow-bank activities pursued by companies that also own or control significant amounts of life insurance-related assets pose to policyholders?

State insurance regulators recognize the loss potential of various activities labeled shadow-banking, such as securities lending. Programs of this nature must be included in the insurer's investment strategy reviewed by state insurance regulators, and there are many disclosures in the public statutory financial statements allowing regulators to monitor the balances. Any changes to the programs are to be reported immediately to the state of domicile at a minimum. After the 2008 financial crisis, regulators adopted additional disclosures in the public statutory financial statement for the collateral held. This allows regulators to identify any changes in the collateral investment types rather than depending on the insurer to notify them.

However, many of these types of programs and activities occur in non-insurance legal entities within a holding company group. State insurance regulators closely watch for participation by the legal entity insurers in the group and address concerns with those as needed. However, even if this activity is happening in an entity not subject to state insurance regulation, our rules and requirements protect against any spillover risk to preserve capital for policyholder obligations.

3. Are there risks to the broader economy related to investment strategies, lending, and other shadow-bank activities pursued by these companies?

The NAIC Financial Stability (E) Task Force's (FSTF) mission is to consider issues concerning domestic or global financial stability as they pertain to insurance. This Task Force is a more recent development compared to the more mature solvency framework for legal entity insurers and insurance groups, but the macroprudential goals greatly benefit from the results of the solvency framework. Most of the efforts to prevent insurer insolvencies, and to maximize the amount of assets available in the event an insolvency is unavoidable, also reduce the risks these insurers pose to the broader economy. However, recognizing the potential for material financial market impacts of a liquidity stress in the life insurance industry, the FSTF recently implemented a Liquidity Stress Test (LST) Framework. This project allows regulators to assess potential financial market impacts from asset sales modeled in life insurer stress tests. Any concerns will be assessed and addressed by the FSTF.

The FSTF's concerns focus on the risks the broader economy can pose to the insurance industry as well as the potential for outgoing risks from the insurance industry, however "shadow banking" is a much broader universe of activity. For this reason, the Financial Stability Oversight Council (FSOC) pulls together the regulatory community to direct attention at these activities and the impact on the broader economy. The State Insurance Commissioner Representative to FSOC also serves a leadership role in the NAIC FSTF. In this manner, the state insurance regulatory system's macroprudential agenda at FSTF stays engaged in the concerns of the broader economy and contributes insurance regulatory insights and expertise to FSOC's work.

4. In cases of pension risk transfer arrangements, what is the impact on protections for pension plan beneficiaries if plans are terminated and replaced with lump-sum payouts or annuity contracts? Specifically, how are protections related to ERISA and PBGC insurance affected in these cases?

The National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) 2016 report titled, "Consumer Protection Comparison – The Federal Pension System and the State Insurance System," speaks directly to this question. The Executive Summary of this report indicates that consumer protections for affected individuals shift from the pension system to the insurance system when an employer purchases annuity contracts to fund its pension plan. It goes on to say:

Even though both systems focus on payer solvency, insurance regulation generally holds life insurance companies to stricter financial standards and more intensive oversight than are applied by pension regulation to single-employer pension plans. As one significant difference, although ERISA places the ultimate funding responsibility on a pension plan's sponsoring employer, ERISA gives pension regulators no control over the financial condition of the sponsoring employer. Pension plan funding is often, but not always, consistent with the plan sponsor's financial condition, and for some purposes pension plan funding levels may fall to as low as 80% of plan liabilities before triggering certain adverse consequences under federal law. ERISA plan sponsors are not meaningfully regulated for solvency, whereas constant solvency regulation is the primary focus of insurance regulation.

Specific to the failure resolution processes and on the financial safety nets provided under each of the two systems, the report says:

In the pension system, the PBGC guarantees pension benefits, within statutory limits. The PBGC receives its funding from insurance premiums charged to active pension plans, investment income, the assets of insolvent plans it takes over, and some additional recoveries against plan sponsors. It receives no direct funding from general tax revenues, and its obligations are not backed by the full faith and credit of the United States. In the insurance system, each state has created a guaranty association (GA) under state law to protect annuity and life insurance benefits for its residents (within statutory limits) as part of a comprehensive insolvency process for failed insurers that allocates a failed insurer's remaining assets to the GAs and to the policyholders (for benefits not

covered by the GAs) as priority creditors on the same priority level. . . . Like the PBGC, the GAs are not directly funded by tax dollars and are not backed by any state's full faith and credit.

The safety net mechanisms differ in significant respects from system to system, and direct comparisons are difficult. In the pension system, for example, the PBGC generally uses a higher maximum guaranty level than most GAs provide. On the other hand, in the insurance system many annuity holders receive, in addition to the GAs guaranteed payments, benefits above the guaranty level backed by more assets from the failed insurance company than what is typically available to plan participants from the assets of failed pension plans. On balance, as reflected in a recent quantitative analysis by Willis Towers Watson commissioned by NOLHGA, both systems provide strong safety nets that cover the vast majority of all benefit claims.

The report is available here: <https://www.nolhga.com/resource/code/file.cfm?ID=2559>

5. Given that many private equity firms and asset managers are not public companies, what risks to transparency arise from the transfer of insurance obligations to these firms? Will retirees and the public have visibility into the investment strategies of the firms they are relying on for their retirements?

At the outset, it is important to note that despite the term “private equity”, many of these firms are indeed publicly traded and therefore subject to all the public reporting and transparency that entails. As described earlier, regardless of PE ownership or not, the individual investments owned by each legal entity insurer are disclosed in the public annual statutory financial statements, and changes to those investments owned are listed individually in quarterly statutory financial statements. This differs from GAAP financial statements, which are reported at a group level rather than a legal entity level, and which do not detail the individual investments owned but rather present higher-level summaries of investments. Also, GAAP financial statements are required for publicly traded companies, whereas legal entity statutory financial statements are required for all US multi-state legal entity insurers, regardless of whether the insurer is publicly traded. Thus, insurers' investment portfolios are fully transparent, much more so than other financial entities.

Again, these statutory financial statement disclosures are monitored by state insurance regulators as well as NAIC investment experts. Changes at the legal entity level, the group level, and broader groupings such as all life insurers or even the entire US insurance industry are assessed. Concerns are addressed with specific legal entity insurers and/or groups, and broader industry concerns may be addressed by NAIC committee groups. The NAIC committees operate under an open meetings policy, so proposals and decisions regarding insurers' disclosure requirements are therefore transparent as well.

6. Are state regulatory regimes capable of assessing and managing the risks related to the more complex structures and investment strategies of private equity-controlled insurance companies or obligations? If not, how can FIO work with state regulators to aid in the assessment and management of these risks?

Without question, our national system of state-based regulation is fully capable of assessing supervising any insurance activity, regardless of ownership structure. State insurance regulators have extensive expertise and insight into the solvency, investments, corporate structure, and management of U.S. insurers at the individual entity and group level. Regulatory financial examiners, actuaries, investment analysts, attorneys, and other specialized experts with decades of experience, coupled with centralized resources of the NAIC, and financial data analysis capability are brought to bear to supervise the largest and most resilient insurance market in the world. We are constantly working to improve and refine our system and its ability to spot emerging risks. Our reserving and accounting system promotes conservatism and policyholder protection.

The NAIC has teams of investment experts with decades of experience in credit and market analysis. Some of those individuals help administer and perform credit quality reviews of the filings submitted by insurers seeking an NAIC Designation for a security. Some help administer the policies and procedures directed by the state regulator members of the NAIC's Valuation of Securities (E) Task Force and monitor the industry investments to ensure all regulators truly understand the risk of the security. Still others perform research on the broader markets and proactively look for issues and concerns for the insurance industry, as well as monitoring the insurance industry's investments for changes in composition, riskiness, etc. Similarly, the NAIC employs actuaries to support the various NAIC committee groups responsible for insurance products, particularly related to reserving practices.

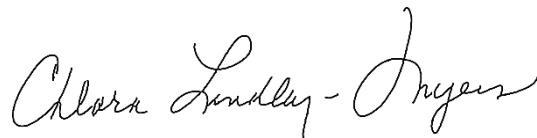
Despite the more recent attention on private equity and insurance in the news, many insurers have been writing complex products and utilizing large and complex investment strategies for some time, so our system has experience at assessing and understanding this dynamic through market highs and lows. State insurance regulators are fully capable of assessing and managing the risks of these insurers, and there is nothing PE firms add to the playing field that changes this fact. It should provide you and the public comfort to know the state insurance regulatory system has already been working on many of the concerns that you and others have highlighted, and we possess the tools and resources to address these issues. State insurance regulation is constantly evolving and improving to ensure that the public trust in the insurance industry is well placed and secure.

If you have any additional questions about private equity or any other issue affecting the insurance sector, we stand ready to answer them.

Respectfully,



Dean L. Cameron
NAIC President
Director
Idaho Department of Insurance



Chlora Lindley-Myers
NAIC President-Elect
Director
Missouri Department of Commerce
and Insurance



Andrew N. Mais (He/Him/His)
NAIC Vice President
Commissioner
Connecticut Insurance Department



Jon Godfread
NAIC Secretary-Treasurer
Commissioner
North Dakota Insurance Department



Michael F. Consedine
Chief Executive Officer
National Association of Insurance Commissioners