Trends in the Ownership Structure of US Insurers and the Evolving Regulatory Landscape

SYNOPSIS

The United States insurance regulatory landscape is experiencing broad changes in reaction to noticeable shifts in ownership structure that have resulted in changing conditions in investment markets and the financial services industry. This report explores insurance industry trends and evolving NAIC guidelines designed to support the new landscape. The report includes a review of the ways in which the new rules help address possible concerns with conflicts of interest associated with forms of ownership and control.

About the authors

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Executive summary

Discussed extensively in The Evolving Regulatory Landscape That Governs Insurers' Investments, the insurance industry is experiencing sweeping changes to its regulatory landscape. The changes are in reaction to two noticeable shifts in the industry that came with the Global Financial Crisis (GFC):

- **Investment strategy.** The low-yield environment had insurers' investment strategy move more heavily toward higher-yielding alternative assets, such as private placements and structured products.[1] We also saw investments accessed through lower-cost, efficient investment vehicles including SEC-registered funds such as Exchange Traded Funds (ETFs) and bespoke private/non-SEC registered funds designed to address insurers' unique needs.
- **Ownership structure.** The shifting investment strategy was coupled with a shifting ownership structure, with private equity (PE) and other asset managers (AM) proficient in originating desirable assets increasingly taking ownership stakes and operating responsibilities in insurers.[2]

The NAIC, the United States Congress, and Treasury, as well as international rulemaking bodies, took notice, and the NAIC initiated a review of changing ownership and investment trends. With an acknowledgment of materiality, regulators proceeded with efforts to refine the rules to have them better aligned with the changing environment, including:

- **Classification and treatment** of concepts including
  - What level of ownership constitutes control, and what the broader set of related party relationships should be considered in the context of investments
  - A move toward a principles-based bond definition when classifying assets that receive more favorable treatment
- **Heightened disclosure** for affiliated and related party investments, as well as insurers' investments more broadly
- **Risk-based capital** and the appropriate level of allocation across investments, in particular, investments in structured products (e.g., CLO tranches) and investment vehicles (e.g., feeder notes)

With trillions of dollars in insurers' investments likely impacted, the multi-year effort to revise the rules will likely result in insurers shifting their governance framework and investment strategies with broader downstream implications for capital markets. This report primarily focuses on US insurers' ownership structure trends and the interplay with the evolving regulatory landscape. This report also touches on how investment strategy interacts with that landscape.

1 Amnon Levy, Evolving CLO Regulatory Landscape, Insurance Asset Risk, 2022.

2 Bill Poutsiaka, Deborah Gero, Amnon Levy, *Investment Advisor-Owned Insurers -- A Proposal for Avoiding Pitfalls and Realizing Benefits*, 2023.

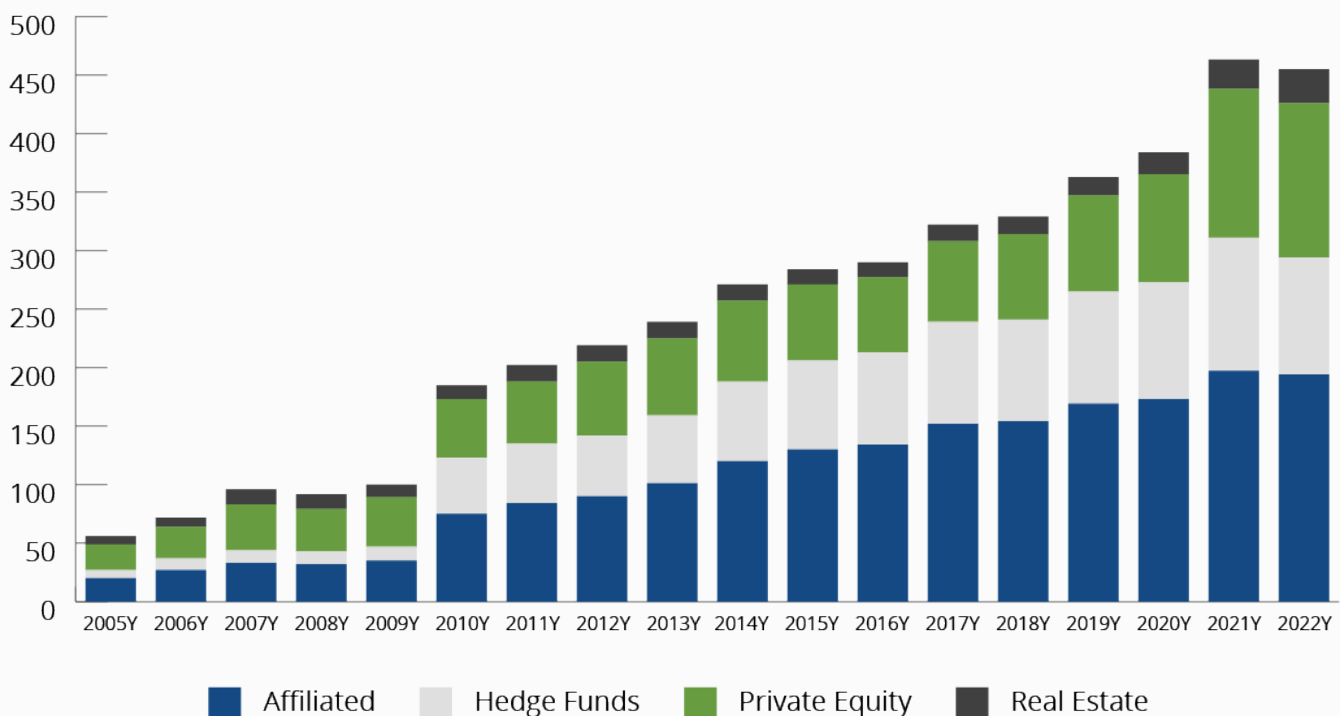
How have ownership and investments changed over the last 10+ years?

Growth in alternative and private investments

The growth in insurers' investments in alternative assets and private assets since the GFC is a general phenomenon, and not limited to PE- and AM-owned insurers. The trend coincides with insurers searching for higher-yielding assets and more cost-efficient investment vehicles.

Figure 1 breaks down other long-term investments reported on Schedule BA, which includes insurers' equity interests in the likes of hedge funds and private equity asset managers sitting at ~$450 billion in YE 2022 well over twice its value ten years ago.

Figure 1: U.S. Insurer Other Long-Term Invested Assets (BACV, $Billion)[3] ; (Source: Bridgeway Analytics using data from S&P Global Markets[4])



> Interesting to observe that aggregate holdings of the form referenced in Figure 1 are not all that different for PE-owned insurers, which constitute 1.5% of their admitted assets when compared to 1.2% for the overall industry.

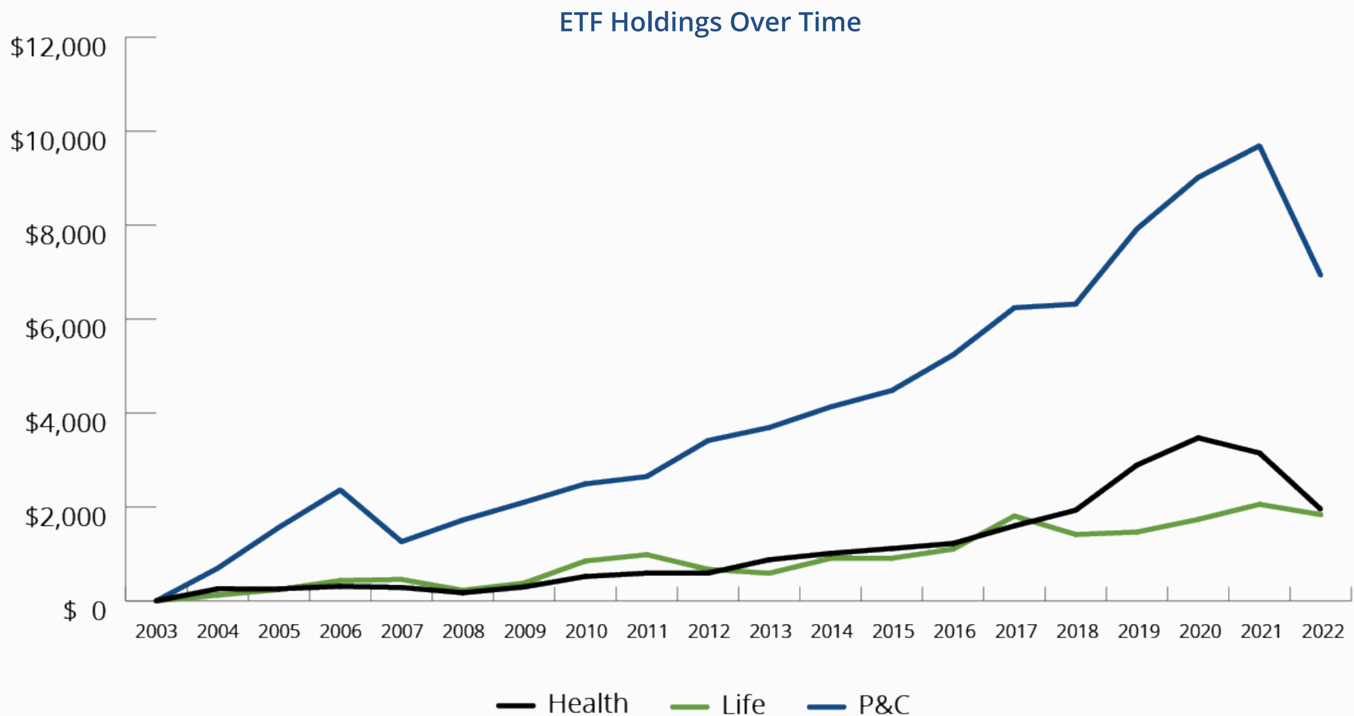
3 Using asset type definitions from Capital Markets Bureau, U.S. Insurer Exposure to Schedule BA (Other Long-Term Invested Assets): Focus on Private Equity, Hedge Funds, and Real Estate as of Year-End 2017. That is using Joint Venture LLCs under schedule BA; mapping Common Stock to Private Equity, Other to Hedge Fund, and summing affiliated over non-fixed income categories.

4 See Appendix.

That being said, there are common aspects of PE-owned insurers' strategy that have been observed to diverge from that of the overall industry. While each insurer tends to follow a unique set of investment strategies to support their unique business model and policy offerings, a common aspect of PE-owned insurers' investment strategies includes holdings that tend to be more heavily weighted toward ABS and other structured assets. PE-owned insurers holding these assets are 13.7% of admitted assets compared to 4% of admitted assets for the overall industry. While most of these holdings are generally viewed as having a high credit quality (NAIC 1 or 2), the divergence in strategy has had regulators and NAIC staff take notice.

Other notable broad industry shifts include investments in private credit with private letter ratings (PLRs) that are often used for credit issued by private investment vehicles. With roughly 8,000 PLRs on ~$300 billion of credit in YE 2022, three times that of YE 2019, the trend points to the use of investment vehicles that are viewed as more effective and efficient including feeder funds and their notes that are relatively low-cost vehicles that provide insurers access to assets that would often otherwise have high associated fixed-costs, limiting their use to larger insurers.[5] The growing use of efficient investment vehicles is also observed in *Figure 2* with the increased use of publicly-traded Exchange Traded Funds (ETFs), which have become more prevalent and can improve efficient transactions, including securities lending, and access to markets that insurers might not otherwise have.

Figure 2: ETF holdings by industry segment (Source: Bridgeway Analytics using data from S&P Global Markets[6])



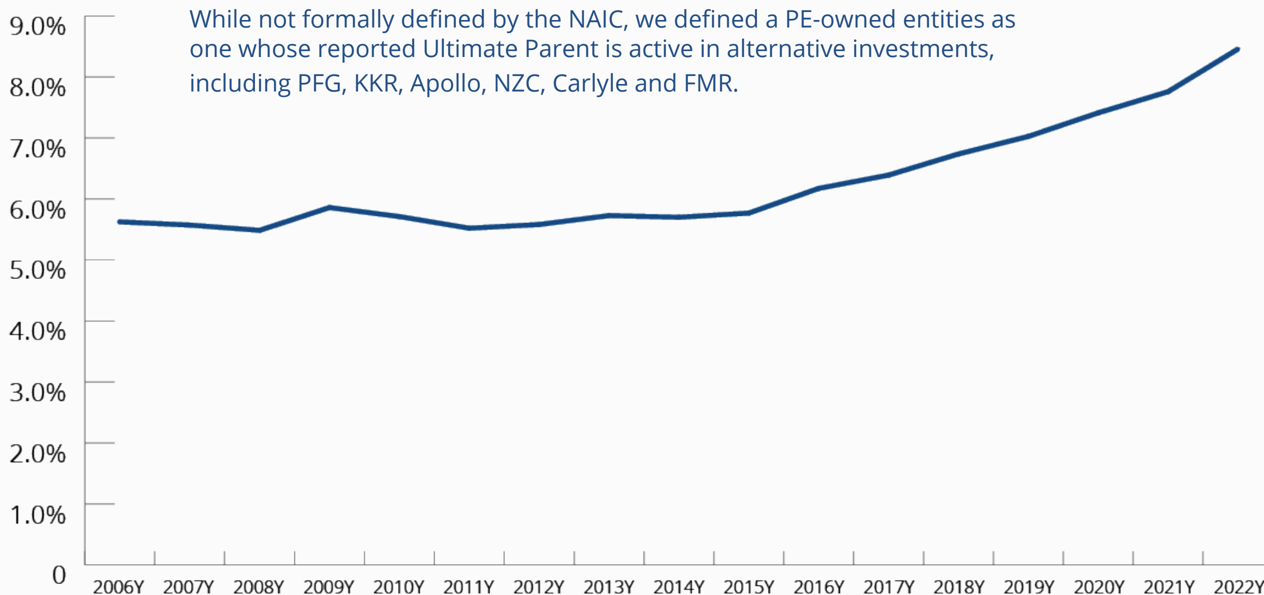
5 For additional discussion, see The NAIC Spring National Meeting Review: What's Next for the Rules that Govern Insurers' Investments as well as Growth in Private Ratings Among U.S. Insurer Bond Investments and Credit Rating Differences.

6 See Appendix.

Ownership trends

The observed shift in investment strategies across the industry was coupled with growth in PE-owned insurance assets. Investments, at a total of $680 billion for YE 2022, were primarily focused on life companies that comprised 98% of the total.[7] The observed shift in ownership can be seen in Figure 3, with PE-owned life insurers increasing from roughly 5.5% ten years ago, to close to 9% today.

Figure 3: Shifts in the ownership structure (Source: Bridgeway Analytics using data from S&P Global Markets[8])



How is access to alternative assets improved with ownership structure?

While insurers have access to alternative, non-traditional, assets through arms-length asset managers, ownership relationship has demonstrated several benefits. By their nature, alternative investment opportunities require an understanding of nuances that are not traditional. As a corollary, the expertise and controls needed to manage those investments for a complex and highly regulated financial intermediary cannot be easily outsourced to an investment manager which is discussed in Investment Advisor-Owned Insurers. As with other aspects of optimal organizational structure, striking the balance and alignment between functions best managed internally and those that are best outsourced should be determined by factors such as costs, incentives, and information flow. In the case of a PE-owned insurer, ownership naturally brings risk sharing that aligns many incentives.

Capital markets and the flipside to capital supplied by insurers

Related to insurers' investment growth in alternatives, it is natural to explore the market's need for capital flows in this direction and the role these assets play in supporting capital markets. Market imperfections can result in barriers to entry and siloed capital markets that provide investment opportunities accessible to a limited number of market participants. Banks and insurance companies for that matter, for example, limit their investments in the syndicated loan market because the risks do not line up with their business models, along with their respective regulators' treatment of lower-rated credit being punitive. Meanwhile, structuring and redistributing these same risks allows insurers and banks to concentrate their investments in high-quality CLO tranches that do align with the risk profile needed to support their business models.

7 While not formally defined by the NAIC, we defined PE-owned entities as ones whose reported Ultimate Parent is active in alternative investments, including PFG, KKR, Apollo, NZC, Carlyle, and FMR.

8 See Appendix.

What were the regulatory concerns with shifting industry ownership and shifting investment trends?

Industries entering less familiar territory flags concerns of ineffective rules

Regulators generally don't regulate hypothetical practices. Rather there is a continuous process of evaluating the environment and appropriateness of the rules, being mindful of implications for costs associated with compliance burdens, possibly related to complex regulations and with implications for competition.

Regulators and markets assessments of trends and risks

While regulators make efforts to stay on top of practice and the appropriateness of rules, the materiality of a trend can be misestimated. We recently experienced this with the dramatic placement of Silicon Valley Bank (SVB) under receivership. Rising interest rates resulted in mounting losses on large positions in long-duration fixed-income assets that SVB and other banks began accumulating during the COVID era, and without having the proper oversight and governance in place. These events are a useful reminder to take a pause and review practice when industries trend into unchartered areas.

The insurance industry experienced an episode like this back in the 80s when ~175 life and health insurer insolvencies made clear the inherent problems with fixed capital standards, initiating the development of the Risk-Based Capital (RBC) framework that was rolled out in the 90s.[9] It highlighted limits with fixed capital standards that did not address the variation in fundamental risks across sectors and companies. Every company was required to hold the same minimum amount of capital, regardless of its financial condition, size, and risk profile. It led to the NAIC's adoption of RBC standards in the early 90s that distinguish:

- Insurers' primary lines of business: (1) life and fraternal; 2) P&C; and (3) health.
- Characteristics, including (1) an insurer's size; and (2) the inherent riskiness of its financial assets and operations.

Bringing it back to shifting ownership trends and the potential for concern

As referenced above, while ownership and related party investments can align incentives, those relationships can lead to a unique set of regulatory concerns in the context of an insurance company and its investment manager. Issues include transparency (undisclosed management fees), fairness (non-market standard management fees), and potential conflicts of interest (bias to overweight investments that the manager can source), with elements that are often difficult to define. NAIC guidance acknowledges that "related party transactions are subject to abuse because reporting entities may be induced to enter transactions that may not reflect economic realities or may not be fair and reasonable to the reporting entity or its policyholders. As such, related party transactions require specialized accounting rules and increased regulatory scrutiny". Examples of transactions that involve potential conflicts of interest that would be concerning to regulators, and new guidelines the NAIC has been structuring to help address those concerns, include:

Investment management fee structure

Undisclosed management fees can lead to a range of perverse incentives with payments that might be viewed as unauthorized dividends. However, those payments cannot be used as a lever by regulators to recapitalize troubled companies in the way that dividends can be. New Asset Adequacy Tests (AATs) overseen by the Life Actuarial (A) Task Force require disclosure of management fees and should provide regulators with a clearer sense of materiality when assessing solvency.

Prudent investment profiles

While there are many factors at play, all else equal, an investment manager that controls an insurance company is incentivized to overweight investments that the manager can source, benefiting from the ensuing management fees. This can result in a portfolio that is otherwise more concentrated in specific asset classes that may be riskier. The new AATs also include specific guidelines for complex assets, that receive punitive treatment under the framework.

9 RISK-BASED CAPITAL, NAIC - Last Updated 12/6/2022

Risk sharing and proper governance are critical, and not limited to PE-relationships

While the PE-owned insurance trend brought issues related to the potential for conflicts of interest to the limelight, those potential conflicts are not new. Thoughtful approaches to governance and risk sharing often align incentives. As an example, part of AIG's GFC bailout included receiving liquidity and capital support through two LLCs, Maiden Lane II, and Maiden Lane III. One of the fundamental properties of the transaction required AIG to retain subordinated positions in the two LLCs, in effect becoming a related party to the bailout risk.[10] The deliberate structuring of a common solvency interest aligned incentives of different parties with otherwise different motives and roles. It ultimately allowed AIG to remain an operating company, and the federal government to recover 100 cents on the dollar, which it exceeded, in the LLCs ultimate liquidation.

At the end of the day, proper governance is critical for mitigating conflicts, ultimately protecting the insurer's policyholders, lenders, and those with equity interests other than the investment manager. Mechanisms should be in place across the organization, with policies specific to each function, including at the board level, that consider the organization's unique structure and potential conflicts, and detailed in Investment Advisor-Owned Insurers -- A Proposal for Avoiding Pitfalls and Realizing Benefits.

What changes has the NAIC rolled out to address concerns?

To improve transparency, heightened reporting requirements were rolled out for affiliate and related party investments, with efforts to define notions related to control that can possibly lead to conflicts of interest. A few notable changes thus far:

- The question of what constitutes control, which often is associated with 10% ownership, is now considered to require a broader set of relationships, referenced as a related party. In this context, it is worth mentioning that NY State issued a Circular Letter emphasizing that "a control relationship can arise from a contract or other factors, in the absence of any ownership of voting securities of an insurer."
- While investment in affiliate and related party debt is generally required to be filed with the NAIC for a designation, with agency ratings not allowable, there are nuanced but important exceptions. In 2022, the Valuation of Securities (E) Task Force adopted several clarifications including:
  - Exceptions, allowing the use of agency ratings for bankruptcy remote entities such as Asset Backed Securities issued by affiliates.
  - Reinforcing statements highlighting state insurance regulators retain the power to require affiliate or related party transactions to be filed with the NAIC for a designation when they would otherwise be allowed to receive agency ratings-based designations.

  How control of an entity can be determined and heightened reporting requirements with affiliated and related party investments which are non-control relationships and haven't fallen under the affiliates' lines (for example, when the underlying credit exposure qualifies as a related party).

  For details, see their 2022 Fall National Meeting Materials and Minutes.
- In the recent Spring National Meeting, the Capital Adequacy Task Force adopted changes that aim to enhance the accuracy and uniformity of RBC calculation concerning affiliated investments in all insurance sectors. The revisions include modifications to the structure and guidelines for RBC computation, ensuring that affiliate investments are treated consistently across the board; for details see their 2023 Spring National Meeting Agenda & Materials and Summary.
- As referenced above, in efforts to further improve transparency, qualifying life insurers must adhere to the new AATs that include reporting and analysis of management fees, related party investments as well as investments in structured securities and other complex assets.

10 Maiden Lane Transactions, Federal Reserve Bank of New York

What additional changes do you expect in the foreseeable future?

Efforts to further refine the rules are evident by Insurer Financial Oversight and Transparency, included as one of six NAIC regulatory priorities for 2023. Plans include resolving several considerations advanced by the Macroprudential Working (E) Group to address financial transparency around private-equity-affiliated insurers, traditional life companies, and related investment activities. In addition:

- Industry and Society of Actuaries continue with efforts to improve on best practices for the new AATs, considering its formidable stage, refining the likes of spread attribution that differentiates investment risks.[11]
- The NAIC continues to explore refinements to the rules for cases that are more nuanced, such as when the insurer is, say, taking on the risk of loans originated by an affiliate or related party when the underlying credit exposures are not affiliated or related parties (e.g., a remote ABS issued by the affiliate), or if the underlying credit exposure has a relationship to the insurer (e.g., a father/son relationship between the owner of the issuer and CEO of the insurer).
- State regulators in the Group Solvency Issues (E) Working Group will continue to explore and frame possible concerns with contractual agreements that might be structured that avoid regulatory disclosures and requirements (Fall National Meeting Materials).

On the international front, the 2023-2024 IAIS Roadmap includes further macroprudential analysis of identified sector-wide themes, one of which is structural shifts in the life insurance sector, including private equity involvement. This will include a deep dive into related activities, such as increased cross-border reinsurance and changes in asset allocation towards more complex, illiquid investments.

What are you optimistic about?

Amnon Levy: Process and transparency continue to prevail as a standard at the NAIC. With models and data used in AATs in a formidable stage, we see regulators collaborating with the industry in setting best practices. This style of deliberation when designing guidelines differentiates the NAIC from other rulemaking bodies.

Bill Poutsiaka: The right questions are being asked on how to balance the multiple interests of parties having stakes in an insurance company, while also recognizing that the answers should vary for different enterprise structures. Explicit recognition of the tradeoffs in each organizational design is critical in all instances.

Scott White: We've taken a very deliberative and transparent approach to broadly identifying and addressing a wide range of potential risks resulting from shifts in ownership structures and investment strategies. I'm confident the ongoing work will ultimately result in more effective rules that better align with these changes in a way that results in a safer and more transparent and competitive landscape. We're also optimistic about recent developments on the international front that we hope will culminate in a recognition that the U.S. AM is an outcome equivalent approach for the implementation of ICS.

10 The Society of Actuaries report describes general principles on methodologies for spread attribution that differentiates investment risks related to requirements of Net Market Spread attribution over the Investment Grade Net Spread Benchmark. While the report lays out principles that can address the required Guideline Excess Spread attribution, it does not propose any specific methodology.

Appendix

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