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Re: Comments Regarding NAIC Macroprudential (E) Working Group Exposed "*Regulatory Considerations Applicable (but not exclusive to) Private Equity Owned Insurers*"

The American Investment Council ("AIC")[1] is pleased to have the opportunity to provide additional comments regarding the National Association of Insurance Commissioners ("NAIC") Financial Stability (E) Task Force ("FSTF") and Macroprudential (E) Working Group ("MWG") exposure, "*Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers*" ("Exposure Document"). As the advocacy, communications, and research organization for the world's leading private equity and private credit firms, which have substantial experience assisting insurers with their investment needs, we believe we are well-positioned to share an important perspective with the NAIC.

As noted in our January 18, 2022 comment letter, the AIC commends the FSTF and MWG for seeking to further understand the longstanding and mutually beneficial

[1] The American Investment Council, based in Washington, D.C., is an advocacy, communications, and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes, and distributes information about private equity and private credit industries and their contributions to the U.S. and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, the AIC's members include the world's leading private equity and private credit firms which have experience with the investment needs of insurance companies. As such, our members are committed to growing and strengthening the companies in which, or on whose behalf, they invest, to helping secure the retirement of millions of pension holders and to helping ensure the protection of insurance policyholders by investing insurance company general accounts in appropriate, risk-adjusted investment strategies. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

relationship between private equity firms, asset managers, the insurance industry and the policyholders they serve. In particular, we applaud the NAIC for taking a deliberative and transparent approach to determining what additional work, if any, should be undertaken to address state insurance regulators' concerns pertaining to the ongoing shift in insurer investment strategies in a persistent low interest rate environment. We also appreciate the recognition by the NAIC in its May 31, 2022, letter to Senate Banking Chairman Sherrod Brown that: (i) many of the Exposure Document's considerations are not unique to one particular category of investors or insurers; (ii) a number of related considerations are currently, or were recently, the subject of deliberation of other NAIC working groups unrelated to private equity, and (iii) notwithstanding the recent attention on the subject, a wide range of insurers have been utilizing alternative investment strategies under the supervision of state insurance regulators for some time. We agree, as you note in the letter, that state insurance regulators are fully capable of assessing and supervising any insurance activity, regardless of ownership structure.[2]

We welcome the opportunity to discuss any questions or comments that FSTF or MWG members may have regarding the Exposure Document or the role of private equity and alternative asset managers in insurance generally, and we would like to call particular attention to the following four Exposure Document Considerations.

Consideration 1 (Disclosure)[3]

We appreciate the recognition by FSTF/MWG that there is no "one size fits all" approach to regulatory disclosures and that this issue is not limited to one category of investors or one sub-set of insurers. To that end, we encourage the FSTF and MWG to extend these fundamental considerations to the entirety of the Exposure Document workstream and to continue to focus on specific *activities*, rather than a particular type of investor or insurer.

As a general matter, we understand that a regulator may need to request that affiliated/related party agreements be submitted as part of certain insurance holding company act review processes, but would request that those materials receive customary confidential treatment. In addition, if and when the Group Solvency Issues (E) Working Group ("GSWG") takes this Consideration up for discussion, we believe it would be

[2] Like insurers, private fund advisers are also subject to significant oversight and regulation. For example, private fund advisers are registered as investment advisers under the Investment Advisers Act of 1940 with the U.S. Securities and Exchange Commission ("SEC"). The SEC seeks to administer and enforce legal obligations on alternative asset managers through an active examination and oversight program, including with an announced focus on conflicts. Insurance companies advised by private fund advisers also receive the benefits of this oversight.

[3] Consideration 1 states: "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)."

helpful for the GSWG to 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.

We also note that there are legitimate business reasons why investors enter into agreements with insurer parent companies or other affiliates that are unrelated to regulator disclosure considerations. Investors enter into these arrangements with insurer affiliates to ensure that those parties support and otherwise refrain from undermining the commitments made at the insurer legal entity level in connection with engaging an alternative manager for services, particularly where the investment manager has made an equity investment in the parent company. These mutually beneficial arrangements ensure that long-term equity investments made in an insurer by an investment manager support the insurer's operations, validate the potential growth of the insurer to other potential investors, and provide alignment between the investment manager and the insurer as a means to ensure the investment manager acts in the interest of the insurer and its policyholders.

Consideration 2 ("Control")[4]

The NAIC *Insurance Holding Company System Regulatory Act* (#440) ("Model Act") defines "control" and provides that control is presumed to exist "if any person, directly or indirectly, owns, controls, holds with the power to vote, or holds proxies representing, ten percent (10%) or more of the voting securities of any other person."[5] To be sure, the Model Act also provides state insurance regulators with the discretionary authority to determine "that control exists notwithstanding the absence of a presumption [of control]."[6]

An established standard as to the facts and circumstances under which control is presumed – and the well-established practices and conventions so associated – is an essential component to providing insurers and investors with regulatory certainty. The need for a clear and predictable presumption to remain in place is critical in order for insurers to effectively and efficiently access capital with predictability, while balancing

[4] Consideration 2 states: "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."
[5] *See* Model Act Section 1(C).
[6] Per the Model Act, such a determination is subject "furnishing all persons in interest notice and opportunity to be heard and making specific findings of fact to support the determination [of control]."

the need for state insurance regulators to have the necessary discretionary authority to effectively supervise insurer transactions.

Moreover, we believe that the Model Act's current definition of "control" continues to be the proper determinant for actual control. Absent traditional indicia of control, contractual arrangements relating to service agreements – including investment management agreements – should not be viewed as providing an indicia of control. Stated differently, 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. To conclude otherwise would impose undue uncertainty on contractual arrangements between insurers and their counterparties, and would likely have a chilling effect on the ability of insurers to enter into agreements that are in the best interest of their policyholders.

Consideration 3 (Investment Management Agreements)[7]

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

[7] Consideration 3 states: "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."

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 funds[8] 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.

[8] *See e.g.,* Hamilton Lane data (February 2021) available at: https://www.investmentcouncil.org/wp-content/uploads/deck-pe-outperformance-aic-2022.02.02.pdf.

[9] Private debt funds outperformed versus investment grade, high yield, and S&P 500 benchmarks by 8 percentage points, 6 percentage points and 6 percentage points, respectively. *See* Private Debt Fund Returns, Persistence, and Market Conditions (Böni and Manigart, April 2022), available at: https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3932484. Additionally, this report observed the average (median) private debt fund provided an internal rate of return of 9.2 (8.5) percent net of fees to limited partners. Moreover, there was a relatively equal outperformance for distressed debt, mezzanine and special situations funds of 8 to 10 percentage points, while direct lending funds outperformed the market by 4 percentage points.

[10] For example, insurers currently comprise approximately 12% of the invested capital in private equity funds. *See e.g.,* Global Private Equity & Venture Capital Report (Preqin, 2021) available at: https://www.preqin.com/insights/global-reports/2021-preqin-global-private-equity-and-venture-capital-report. The attractiveness of the net returns offered by private equity investments is also evidenced by the extent to which institutional investors will be increasing or maintaining their allocation to such investments in the next year. *See* LP Perspectives 2021 (Private Equity International, December 2020) available at: https://www.investmentcouncil.org/wp-content/uploads/deck-pe-outperformance-aic-2022.02.02.pdf.

Consideration 10 (Privately Structured Securities)[11]

As you are aware, insurance company asset managers are tasked with producing enough yield from their investments to keep pace with benefits and obligations embedded in policies that often stretch years into the future, while not running afoul of state insurance investment laws. These obligations have been challenging as of late due to the persistent low interest rate environment, leaving insurers with two essential choices: (i) take more risk along the yield curve in search of higher rates of return; or (ii) seek other types of debt instruments that provide for more attractive returns without incremental credit risk. This set of circumstances is increasingly driving insurers to seek 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

[11] Consideration 10 states: "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.)"

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[12];
- 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.[13]

We welcome the opportunity to serve as a resource to the NAIC as it continues to address this important matter.

Respectfully submitted,

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American Investment Council

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[12] *See* Analysis of Historical NRSRO Ratings Data (Morgan Stanley, February 2022), available at: https://mcusercontent.com/65ee38c99561aeba4a1f82919/files/ff9650b4-dfa7-2815-f41a-fa7a60d85fbf/Final_Morgan_Stanley_Report_18_.pdf.

[13] *See e.g.,* Cambridge Associates data (August 2021) available at: https://www.investmentcouncil.org/wp-content/uploads/deck-pe-outperformance-aic-2022.02.02.pdf. In fact, prominent institutional investors believe that the inclusion of private investment can produce high returns with lower risk. *See* Yale Endowment Report (2019) available at: https://static1.squarespace.com/static/55db7b87e4b0dca22fba2438/t/5ebbf53c4b59573668cd85cf/1589376317984/2019+Yale+Endowment.pdf.