ASSISTANT SECRETARY
FOR LEGISLATIVE AFFAIRS

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C.

June 29, 2022

The Honorable Sherrod Brown
United States Senate
Washington, DC 20510

Dear Senator Brown:

Thank you for your letter dated March 16, 2022, regarding the growing role of alternative asset managers, such as private equity firms, in the U.S. insurance sector. As you noted, the Federal Insurance Office (FIO) highlighted in its 2020 and 2021 Annual Reports its interest in monitoring these trends and assessing their regulatory implications.[1] And, as your letter suggests, FIO agrees that these activities in the life insurance sector, including with regard to retirement and savings products, raise important questions. Our response begins with an overview of the changes in the investment composition of U.S. life insurers and the emergence of private equity and other alternative investment managers in the life insurance business, then discusses the evolving risk profile of life insurers. Next, the response outlines some potential implications for policyholder protection in light of these market dynamics, including with respect to the Pension Benefit Guaranty Corporation (PBGC). Finally, Treasury's response notes FIO's current priorities in this area over the coming months, and concludes by highlighting ongoing regulatory developments in the National Association of Insurance Commissioners (NAIC) and U.S. states.

A. The U.S. Life Insurance Market and Emergence of Private Equity

The U.S. life and health insurance sector—which offers life insurance, annuities, and accident and health products—constitutes about one-third of the total U.S. insurance industry by premium volume. Premiums, considerations, and deposits in 2021 for this sector were approximately $821 billion, while insurers in this sector held approximately $8.5 trillion in total assets (including $3.3 trillion in separate accounts) at year-end 2021, accounting for over two-thirds of the insurance industry's total assets.

As private markets have expanded over the last decade, far outpacing the growth of public markets, private equity firms have reshaped their business models and increased involvement in the life insurance sector. Previously, the focus of private equity was largely on buy-outs. Now, some private equity firms are increasingly pivoting their business objective to the private credit market and to raising more "permanent" capital to support this business. To that end, some

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[1] *See, e.g.*, FIO, *Annual Report on the Insurance Industry* (2020), 121-122, 124-126, https://home.treasury.gov/system/files/311/2020-FIO-Annual-Report.pdf (*2020 Annual Report*); FIO, *Annual Report on the Insurance Industry* (2021), 50-52, https://home.treasury.gov/system/files/311/FIO-2021-Annual-Report-Insurance-Industry.pdf (*2021 Annual Report*).

private equity firms have increased their access to books of annuities and life insurance through purchases of insurers. With their steady cash flows, annuity and life insurers can provide private equity firms an opportunity to scale the growth of private credit strategies, to obtain a reliable long-term source of capital, and/or to have an in-house customer that provides a consistent stream of fees.[2]

Certain metrics regarding the increased participation of private equity firms and other alternative asset managers in the life insurance sector demonstrate the scale of these activities and the basis for increased regulator and policymaker focus.[3] At year-end 2020, the cash and invested assets of U.S.-domiciled private equity-owned life insurers were over $471 billion; by year-end 2021, private-equity-owned insurers likely controlled in excess of $800 billion.[4] This growth greatly outpaced the overall asset growth rate of U.S.-domiciled life insurers during the same period. A substantial amount of additional assets are also held by private equity-owned or affiliated offshore life reinsurance entities that mostly reinsure U.S. business.[5] Private-equity-owned reinsurers are significant sources of reinsurance for U.S. domiciled affiliates and for unaffiliated U.S. insurers.[6]

Since shortly after the financial crisis, private equity capital has been a stable funding source for growth of insurance market participants and also has served to improve returns by generating higher investment gains. However, through their expanding roles as owners of insurers and as third-party asset managers for insurers, private equity firms have significantly heightened their exposure to and influence over the life and annuity insurance industry, which is a departure from their typical activities and merits further attention. Additionally, as private equity firms have been transferring money from traditional low-yield investments into less-liquid assets that are reflective of their own investment strategies, and which may raise complexity risk, their various operating structures and activities have also become a matter of considerable interest for policymakers.

Life insurers' investment portfolios increasingly include other examples of alternative and other non-traditional asset classes, such as private placements, private-label securities, and other structured securities including collateralized loan obligations (CLOs) and asset-backed securities. For example, life insurance industry alternative assets grew from $161 billion in 2016 to $238 billion in 2021, while asset-backed securities and other structured securitization assets grew

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[2] *See, e.g.*, Sebastien Canderle, "Permanent Capital: The Holy Grail of Private Markets," *CFA Institute Enterprising Investor*, June 1, 2021, https://blogs.cfainstitute.org/investor/2021/06/01/permanent-capital-the-holy-grail-of-private-markets/.

[3] *See, e.g.*, FIO, *2020 Annual Report*; FIO, *2021 Annual Report*.

[4] *See* FIO, *2021 Annual Report*, 50; Kerry Pechter, "Private Equity in the Life/Annuity Biz," *Retirement Income Journal*, April 28, 2022, https://retirementincomejournal.com/article/private-equity-in-life-annuity-biz-conference-notes/. *See also* Tim Zawacki, "Large Deals Elevate Private Equity-Linked Reinsurers in US Life, Annuity Market," *S&P Global Market Intelligence*, May 3, 2022, https://www.spglobal.com/marketintelligence/en/news-insights/research/large-deals-elevate-private-equity-linked-reinsurers-in-us-life-annuit.

[5] *See, e.g.*, Kerry Pechter, "Bermuda's Role in a Changing Annuity Industry," *Retirement Income Journal*, September 10, 2021, https://retirementincomejournal.com/article/bermudas-role-in-a-changing-annuity-industry/.

[6] *See also* Tim Zawacki, "Large Deals Elevate Private Equity-Linked Reinsurers in US Life, Annuity Market."

to $393 billion in 2021.[7] Relatedly, and included in alternative assets, investments by insurers in private equity funds increased from $58.7 billion in 2016 to $117.4 billion in 2021.[8]

B. Evolving Risk Profiles of Insurers

The sustained low interest rate environment in recent years, together with the monetary stimulus taken to address the COVID-19 pandemic, created challenges for the insurance industry. Largely in response to this "low for long" situation, insurers have been raising the risk exposure of their portfolios to enhance yield in support of their product mix and increasingly turned to private markets as part of these efforts. Thus, investment portfolios of insurers have included a greater number of alternative and other non-traditional asset classes, as noted above. If done in a balanced and measured approach, with appropriate regulatory oversight and insurer risk management, these investment activities could help to diversify insurer portfolios, lower market correlations, and provide better yields. Such outcomes could also support insurer resilience and the long-term interests of annuitants and policyholders. However, a greater concentration of such assets on the books of insurers also elevates potential liquidity and complexity risks of investments that are increasingly comprising the assets supporting surplus and policyholder obligations. This growth could potentially amplify market shocks experienced by insurers in the event of an abrupt price correction or other systemic market dislocation.

How these assets are concentrated among insurers in supporting liabilities can vary significantly across the life insurance sector, highlighting the need for the U.S. regulatory capital framework to be appropriately aligned to properly capture the evolving nature of risks arising from such shifts in investment behavior. One area, in particular, that merits further attention by regulators and the NAIC is whether it remains appropriate to apply the same risk-based capital treatment to CLOs and other structured securities with risk profiles that may diverge significantly from those of corporate bonds.[9]

FIO has been monitoring these ongoing market developments and activities, while considering their macroprudential implications. Specifically, the growth of alternative and non-traditional investments in the insurance sector may be associated with the potential amplification and migration of risk in at least the following ways:

1. Regulatory incentives may help drive private equity-owned insurers to incorporate substantial reliance on offshore risk-bearing entities for certain blocks of business,

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[7] *See* FIO*, 2021 Annual Report*, 24; "U.S. Insurance Industry Cash and Invested Assets at Year-End 2016," *NAIC* and *Center for Insurance Policy and Research Capital Markets Special Report*, https://content.naic.org/sites/default/files/capital-markets-special-report-cash-invested-assets-2016.pdf; Michele Wong and Jean-Baptiste Carelus, "U.S. Insurance Industry's Cash and Invested Assets Surpass $8 Trillion at Year-End 2021," *NAIC Capital Markets Special Report*, https://content.naic.org/sites/default/files/capital-markets-special-reports-asset-mix-ye2021.pdf.

[8] *Best's Special Report*, "Strong Performance, New Investment Drive Private Equity Growth," May 24, 2022.

[9] *See, e.g.*, NAIC Financial Stability (E) Task Force, "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers," available in NAIC, *Joint Meeting of the Financial Stability (E) Task Force and the Macroprudential (E) Working Group* (April 5, 2022), Appendix B, https://content.naic.org/sites/default/files/national_meeting/Agenda%20%26%20Materials%20v2.pdf.

potentially masking from U.S. regulators the full scope and magnitude of risk to U.S. policyholders.

2. The increased interconnectivity of the U.S. and Bermuda insurance markets through the growth of private equity-owned insurers may have implications for U.S. policyholders.

3. The increased use of complex investment strategies has led to the greater prominence of illiquid and volatile assets on insurers' books. This could contribute to potential market liquidity concerns, valuation challenges, uncertain levels of credit risk, and potential concentration risk, which could intensify under situations of economic uncertainty or dislocation.

4. Firms may be leveraging opportunities for capital arbitrage that may exist, in part, because regulators and the NAIC have not fully aligned supervisory frameworks with market developments, including securitization structures, allowing for the assumption of new and greater risks by insurers that may not be appropriately captured in regulatory capital requirements. In this regard, FIO is supportive of efforts by the NAIC to revise and consider improvements to its Securities Valuation Office (SVO).[10]

5. Through the expertise and business models of their private equity affiliates, alternative asset managers and private equity-owned insurers have access to diversified channels to source private credit, enabling them to engage in more complicated transactions, and to take positions with increased levels of interconnectedness and reduced levels of transparency on the amount and distribution of risk across the rest of the financial system, as compared to other insurers.

C. Potential Implications for Policyholder Protection

Whether viewed at a macroeconomic or an individual firm level, it is important to consider whether and how the observations described above may affect insurance policyholders, including whether they may contribute to an increased potential for insurers to be unable to meet their promises to those policyholders. As a start, FIO assesses that the following issues merit further consideration and are generally aligned with the NAIC's current work in evaluating the implications of private equity participation in the insurance sector:[11]

1. Whether a potential misalignment may exist between the shorter-term objectives/strategy of the alternative asset manager investment model and the long-term commitment necessary for fulfilling annuity/life insurance policyholder interests.

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[10] *See, e.g.*, "Valuation of Securities (E) Task Force, NAIC, https://content.naic.org/cmte_e_vos.htm (noting that 2022 adopted charges include: "Review and monitor the operations of the NAIC Securities Valuation Office (SVO) and the NAIC Structured Securities Group (SSG) to ensure they continue to reflect regulatory objectives.").

[11] The NAIC has identified similar areas of examination. *See, e.g.*, NAIC Financial Stability (E) Task Force, "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers," available in NAIC, *Joint Meeting of the Financial Stability (E) Task Force and the Macroprudential (E) Working Group* (April 5, 2022), Appendix B, https://content.naic.org/sites/default/files/national_meeting/Agenda%20%26%20Materials%20v2.pdf.

2. Whether policyholder interests are sufficiently protected from the effects of potential conflicts of interest within private equity organizational structures (such as management/investment fees; operating strategies that result in highly levered balanced sheets; use of third-party asset managers; and sourcing from affiliated origination platforms).

3. Whether inadequate levels of transparency regarding the risks inherent in the highlighted investment strategies may contribute to insufficient requirements for reserving of liabilities and capital held for unexpected losses, potentially exposing the state guaranty system in the extreme case of insurer failure and potential contagion risk. The involvement of private equity firms could also complicate any future resolutions in case of such failures. Relatedly (see Section D below), in the case of pension risk transfer transactions, further examination regarding trade-offs from the loss of PBGC backing may be warranted

4. Whether there are implications for the safety and soundness of insurer obligations in view of the offshore domicile of affiliated and unaffiliated reinsurers involved in the private equity-owned insurance business, which in some instances have resulted in large capital releases following insurers executing affiliated reinsurance transactions. This type of activity suggests that these deals could be motivated by regulatory arbitrage opportunities (such as allowing reduced reserves to back policyholder obligations).

D. Pension Risk Transfer Arrangements and the PBGC

Your letter asks about pension risk transfer (PRT) arrangements and the PBGC. Defined-benefit PRT arrangements, including lump-sum payouts or group annuity contracts, are designed to transfer longevity or investment risk from plan sponsors to insurance companies or to the participants themselves. Such risk-transfer arrangements may present both potential benefits and risks for plan participants. For example, such transactions may allow participants to receive lump-sum payouts, but participants should carefully consider that in accepting such arrangements they are assuming all future investment and longevity risk. Participants must make a difficult decision in deciding between the relative merits of a lump sum payout compared to remaining with the plan, or, in the case of a terminating plan, accepting coverage under a group annuity contract. Such a decision may involve a complex set of considerations, including the loss of existing guaranteed income benefits; the participant's ability to manage the funds from a payout; the participant's health and expected longevity (and potentially their spouse's as well); and taxation implications.

For risk-transfers involving group annuity contracts, which a plan sponsor may implement without offering participants a choice of a lump sum or remaining with a non-terminating plan, participants would be exposed to the financial health of the insurer and, in the event of the insurer's failure, the specific protections available through state insurance guarantee programs. U.S. insurers are highly regulated by the U.S states, in order to support their ability to meet their long term commitments to policyholders. Plan sponsors are not generally subject to similar regulation and are not typically in the business of retirement security. Life insurers play an important role in Americans' retirement security and so PRT transactions may be beneficial for plan participants who become annuitants.

It is important, however, that the transactions be transparent to participants. Policymakers should also consider how the increasing role of private equity in this space may affect the interests of plan participants. For example, for insurers owned by private equity firms, the considerations noted in the previous sections of this letter may also bear on their role in PRT.[12] The use of reinsurance sidecars (typically offshore affiliates, which allow private equity firms to source on-demand equity capital to seek deals), enhanced by their capacity to assume spread and longevity risks, may facilitate the ability of private equity-owned insurers to increase their presence in the PRT market. It is important that such insurers are committed to supporting such obligations to policyholders over the long term.

U.S. state guaranty associations' backing of insurer obligations operate in different ways, and under different financial parameters, than the PBGC's guarantee of pension benefits for plan participants.[13] Among other differences, the amount of protection available after a risk-transfer in various states may differ from the guarantee amounts provided for by the PBGC (and may differ from state to state). Under either type of risk-transfer arrangement, participants would lose the protections provided by the PBGC and by ERISA. However, there are some mitigants to this loss of protections because, in order to comply with requirements under the Internal Revenue Code, any group annuity contract must replicate certain plan provisions, such as the right of a participant who has not commenced benefits to elect among the forms of benefit that were available under the plan.

While risk-transfer arrangements generally help reduce a plan sponsor's pension-related obligations and related financial risks, the reduction of the plan participant population can impact remaining participants in a non-terminating plan as well as participants in other defined benefit pension plans. Remaining participants may be impacted if such risk-transfers weaken the funded status of a non-terminating plan, which would subject them to a heightened risk of plan failure. By reducing the defined benefit plan participant population, risk transfers can also impact other defined benefit plans through potential effects on the PBGC's insurance program. All else being equal, a smaller participant population would generally both reduce the future insurance premiums collected by the PBGC for a covered plan and reduce the benefit amounts that the PBGC would be responsible for insuring. Whether such risk transfer arrangements, on balance, result in a net strengthening or weakening of the PBGC's financial position depends on a range of factors, including the specific conditions of a given PRT transaction. The PBGC has found that financially weak plan sponsors engaged in risk-transfer arrangements (where plans are not terminated) at a similar rate to other plan sponsors, which may indicate that participant populations are declining proportionately among risky and less risky plans.[14]

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[12] The NAIC's list of regulatory considerations for private equity includes "The trend of life insurers in pension risk transfer (PRT) business and supporting such business with certain of the more complex investments." *See* NAIC, https://content.naic.org/sites/default/files/national_meeting/Agenda%20%26%20Materials%20v2.pdf.

[13] *See* "Facts & Figures," National Organization of Life and Health Insurance Guaranty Associations, https://www.nolhga.com/factsandfigures/main.cfm.

[14] PBGC reports that it does not have data to estimate whether risk transfer arrangements may change the magnitude of potential future claims. PBGC, *Analysis of Single-Employer Pension Plan Partial Risk Transfers* (October 2020), https://www.pbgc.gov/sites/default/files/2020-risk-transfer-report.pdf.

Overall, however, the PBGC continues to report that its Single-Employer Program remains financially healthy with a positive net position of $30.9 billion at the end of FY 2021, compared to $15.5 billion at the end of FY 2020, an improvement of $15.4 billion.[15] Moreover, the PBGC's projections also show that the Single-Employer Program is expected to remain strong through the next 10-year projection period across a range of potential scenarios.

E. FIO Priorities

As FIO continues to monitor developments in this space and to consider implications for policyholders and the financial system, it will be particularly focused on the following four areas:

Liquidity: Liquidity and the appropriate regulatory responses in view of the transition from traditional asset classes such as bonds to more non-traditional classes that are higher yielding but less liquid, including real estate, CLOs and other privately structured securities. FIO's focus in this area includes:

- **Heightening the monitoring of the life insurance sector's investment strategies**. As described above, an increasing allocation to illiquid and structured private label asset classes to support reserve portfolios is a key attribute of a growing segment of the U.S. life insurance business and could potentially mask the scope and depth of risk. While illiquid assets allow insurers to capture spread premium, the volatility associated with these holdings can expose them to greater economic losses under market stress when asset values become depressed and the ability to generate cash flow to fulfill policyholder obligations could become strained.

Credit Risk / Capital Adequacy: Credit risk and loss-absorbing capacity and the appropriate regulatory response in view of activities that link affiliated origination platforms, securitization strategies, and asset allocation approaches. FIO's focus in this area includes:

- **Reviewing the current supervisory and capital frameworks** that may be linked to more traditional investments and working with state regulators to ensure that these frameworks (including the ratings processes at the SVO and the capital treatment and classification for bespoke securities) are properly aligned with the growth and nature of alternative investments in mitigating new and emerging risks. These frameworks take on added importance in an environment where insurers may seek to maximize capital efficiencies through potential regulatory arbitrage opportunities that may amplify risk.

Offshore Reinsurance Implications: Monitoring the growth of offshore reinsurance and assessing why segments of the market are increasing their reliance on affiliated and unaffiliated reinsurance entities. The migration of interest-sensitive longevity business to a few offshore insurance jurisdictions through affiliated and non-affiliated reinsurance transactions has increased in recent years. The speed and scale of this development suggests the need for regulators and policymakers to better understand the role of offshore reinsurers and whether regulatory capital arbitrage opportunities, tax advantages, and other potential gaps that are not

[15] PBGC, *Annual Report 2021*, https://www.pbgc.gov/sites/default/files/documents/pbgc-annual-report-2021.pdf.

under the oversight of U.S. regulators are obscuring (or even amplifying) the level of risk stemming from these activities.

<u>Conflicts of Interest</u>: Issues regarding potential conflicts of interests arising from management and investment fee structures and sourcing from affiliated origination platforms. FIO will continue to consider the possible influence of conflicts of interest as drivers of potentially sub-optimal investment activity. FIO will also continue to evaluate business expectations and objectives (short-term gains versus long-term commitment) and the associated implications for policyholders and the broader market.

F. NAIC and U.S. State Regulatory Developments

FIO has been engaging with the NAIC and state regulators to consider the potential impact of the trends described above and how, in light of these evolving market developments, the current regulatory framework may need to be modified so that it continues to enable regulators to safeguard policyholder interests and address potential macroprudential risks. The NAIC's Financial Stability Task Force has publicly exposed its work on these topics (partly described in Parts C and D of this letter), and has requested stakeholder comments on its initial "List of Regulatory Considerations – PE Related and Other."[16] These considerations are broadly aligned with FIO's areas of priority described above. FIO will continue to monitor this work of the NAIC's Financial Stability Task Force, and encourages continued focus and increased progress by state regulators in this area.

Further, while reasonable concerns are being expressed about the alignment of private equity firm objectives with the long-term commitment underlying annuity and life insurance policies and related policyholder protections, FIO shares the view that the NAIC's regulatory focus should be more on the activities of firms involved in this sector than on any specific business model. FIO will also continue to welcome further opportunities for engagement with the insurance industry to better assess these market trends and to gain insight on how current business models and operating strategies may continue to change in view of the evolving macroeconomic situation, including the potential implications of the rising interest rate environment, and regulatory responses.

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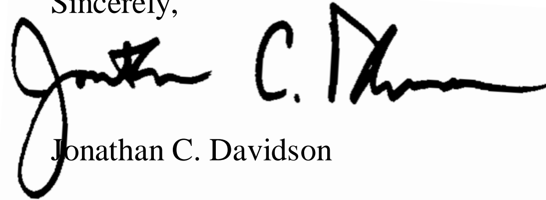
FIO appreciates the concerns and issues highlighted in your letter, and is taking steps to ensure that they are fully considered. With regard to both legacy and new business, life insurers have an incentive to seek structures and opportunities that will support their ability to provide innovative products and meet their commitments to their U.S. customers. FIO will continue to monitor the increasing presence of alternative asset managers and their alignment with these interests. Further, new business approaches may require new or enhanced supervisory approaches so that American consumers can be confident that regulators are sufficiently focused on the risks that insurers are taking with the assets supporting their commitments to policyholders.

[16] Financial Stability (E) Task Force, "Regulatory Considerations Applicable (But Not Exclusive) to Private Equity (PE) Owned Insurers."

If you should have any further questions, please contact the Office of Legislative Affairs.

Sincerely,



Jonathan C. Davidson

cc: Mr. Dean L. Cameron