

# Investments by Insurers: How They're Regulated and Why It Matters

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According to the Insurance Information Institute, U.S. insurance companies in the aggregate hold about \$8.5 trillion of cash and invested assets. These assets support insurers' ability to pay claims to policyholders. In recent years, government bodies have attempted to influence these investments using the levers of insurance regulation—from state “name and shame” laws on investments in coal, to restrictions on investments in Iran, to calls from the Trump Administration to ease infrastructure investments. Understanding the background and interplay of the insurance laws that govern investments by carriers can provide some context to these developments and also shed light on a key aspect of solvency regulation of this critical U.S. industry.

Regulatory restrictions on insurance company investments are

motivated by the risk that, if an insurer were to experience greater-than-expected losses on invested assets, the insurer might not be able to pay claims by policyholders. State legislatures and regulators cannot guarantee the performance of investments, of course, but they can and do impose guardrails on investment activity that, theoretically, reduce risk. Although often aligned with one another, the statutory tools and mechanisms used by regulators to conduct this oversight are not fully integrated, which can lead to some regulatory uncertainty and can affect investment activity.

Insurers are required to file annual and quarterly statements, referred to variously as statutory

statements, “blanks” (because they are in the nature of a fillable form) and “blue books” and “yellow books”, for the color of the cardstock paper in which they are bound (blue for life insurers, yellow for property-casualty). Among the voluminous quantitative information required to be provided in annual statutory statements are detailed schedules, asset-by-asset, of the financial instruments held for investment and acquired or divested over the prior year. These are classed in one or more investment schedules by type, e.g., Schedule B for mortgage loans, Schedule D for bonds and stocks and Schedule BA for “other invested assets.”



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Which schedule a particular investment falls on usually determines how much additional capital the insurer will be legally required to hold on its balance sheet against that investment (that is, against the risk that the investment fails) under state “risk-based capital” (RBC) laws. For example, all other things being equal, the insurer will be required to hold more capital against shares of stock included on Schedule D than mortgages included on Schedule B, insofar as equity investments by their nature carry more economic downside risk than do debt obligations such as mortgages.

Second, insurance companies are required to maintain accounts using statutory accounting principles (known as SAP or Stat), as opposed to Generally Accepted Accounting Principles (GAAP), the standard accounting regime for public companies in the United States (Note that, for insurance companies that are subsidiaries of a publicly-traded holding company—a typical ownership structure—the parent or group will have GAAP financials, and each regulated insurer downstream will maintain its own accounts in Stat.) SAP provides guidance on, among other things, how an insurer must account for and include a particular investment on its balance sheet. In setting forth these requirements, SAP often provides

definitions of particular types of investments. For example, Statutory Statement of Accounting Principles (SSAP) No. 37 (on mortgages) defines “*mortgage*” as a debt obligation “that is not a security, which is secured by a mortgage on real estate”, including “mortgages acquired through assignment, syndication or participation.” It also defines “*security*” as a “share, participation or other interest” of an issuer that is (1) represented by a bearer or registered instrument, (2) of a type traded on a

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securities exchange or (3) divisible into a class or series. Other SSAPs define such categories as mezzanine loans, affiliate investments and derivative instruments.

The two regimes described above—(1) annual statement reporting/RBC and (2) statutory accounting—are essentially uniform nationwide across all states and administered by the National Association of Insurance Commissioners (the NAIC), the preeminent standard-setting body for the

insurance industry in the United States. The third regime, permitted investment laws, reveals much more differentiation among the states despite the presence of NAIC model laws on this topic as well. These state laws, such as Article 14 of New York’s insurance law (NYIL), impose detailed diversification requirements on the investments of an insurer domiciled in the state. (There are NAIC model laws on permitted investments, but they have not been uniformly adopted by the states.) For instance, New York’s provisions prohibit a life insurer from investing in a single mortgage in an amount that exceeds two percent of all admitted assets (or \$30,000 if greater); under Delaware law the aggregate value of an insurer’s stock investments (other than subsidiaries) may not exceed 40 percent of the insurer’s assets; and so on. Investments that do not conform to the qualitative or quantitative standards of state investment laws cannot be counted toward (“admitted to”) the insurer’s capital and surplus, a key metric of financial strength. Some states also *prohibit* specific types of investments (as opposed to merely “non-admitting” them); acquiring such an investment can result in the regulator’s ability to compel the insurer to divest itself of it. Examples of prohibited investments for New York-domiciled property-casualty insurers include

shares of the insurer's parent company and securities issued by a corporation that is majority-owned by the insurer's officers or directors.

With respect to investment securities, an important component of these state laws is the rating system administered by the NAIC's Securities Valuation Office (SVO), which evaluates the credit quality of debt securities. State investment laws frequently cite this system in setting quantitative requirements. For instance, many states' laws restrict the amount of lower-grade securities that can be held, where "lower-grade" is 4, 5 or 6 on a scale that generally runs from 1, the highest credit quality, to 6, the lowest.

In most cases, the classification of an investment under the three regimes will be internally consistent. For instance, a straightforward commercial mortgage would be included in Schedule B, with a concomitant RBC capital charge, would be accounted for pursuant to SSAP No. 37 and would be subject to the domiciliary state's statute on mortgage investments. In the case of a New York-domiciled property-casualty carrier, the investment would have to meet the requirements of NYIL §1404 ("loans secured by real estate") and, in the case of a life insurer domiciled in New York, NYIL §1405 ("obligations secured by real property or interests therein"). Increasingly, however, given the complexity of

the capital markets and investment opportunities available to insurers, specific transactions defy easy categorization across these regimes. This comes up, for instance, in structured mortgage products that combine features of multiple underlying properties or have hybrid features of both a mortgage and a corporate obligation. In recent years, this phenomenon has also been visible in fund investments such as money market, bond or mortgage funds, which would be listed on Schedule BA as an "other long-term invested asset" but could, in certain cases, be accounted for on a "look-through" basis (that is, disregarding the fund entity and looking to the underlying asset contained *within* the fund). The more favorable RBC treatment (debt) might be available despite the formally equity nature of the investment. There are different approaches among reporting companies, furthermore, on how to characterize these for state investment-law categorization purposes (i.e., as equity or debt instruments).

Recent years have seen state regulators and even the federal government use the investment regime to advance public-policy causes not directly related to solvency. Key examples include:

- New York enacted a statute (NYIL §1415) in 2014 non-admitting Iran-sourced investments.
- In 2016, the California Insurance Commissioner began requiring insurers to disclose their fossil

fuel investments and asked insurers to voluntarily divest from thermal coal. California cited the "risk [that] thermal coal could become a stranded asset on the books of insurance companies." The NAIC continues to look at fossil fuel investments as part of a broader climate-risk initiative.

- In 2017, the U.S. Treasury Department released a report on insurance and asset management in which the Administration called for states to take a more flexible approach on insurance company investments in infrastructure, including revisions to RBC laws, to make these investments more attractive.

It is fair to question the wisdom or propriety of using investment laws, which by their nature are motivated by the goal of enhancing insurer financial strength, to advance politicians' priorities and projects, no matter how well-intentioned. For the time being, however, these laws remain an important—if not holistically integrated—framework for state oversight of insurer investment activities.