Private Equity:

National Council of Insurance Legislators Conference

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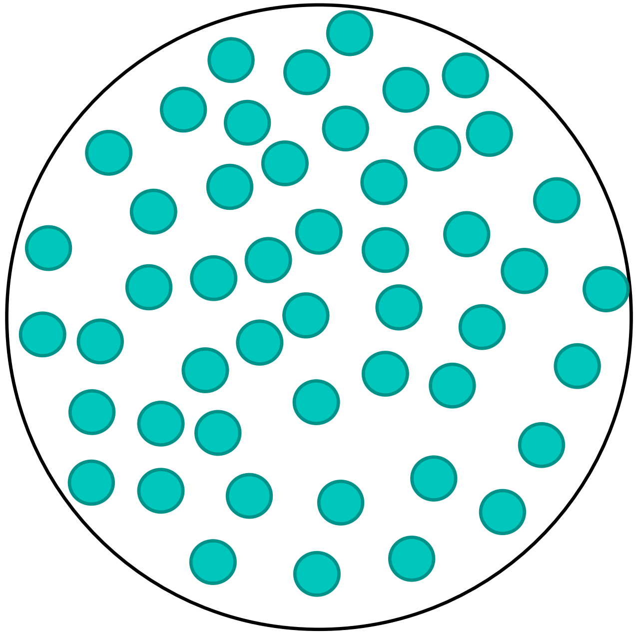
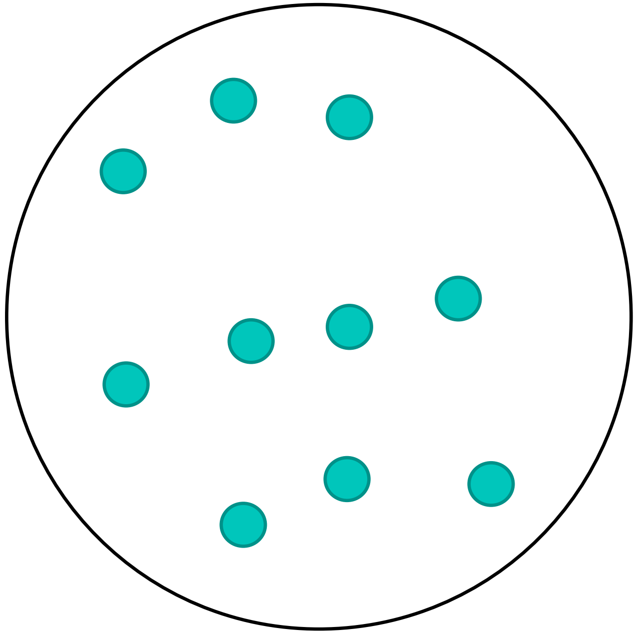
What is Private Equity?

Publicly-traded Stock Mutual Fund



Owns hundreds of publicly-traded stocks like Amazon, Exxon, and General Electric. Indefinite life. Fund investors can "cash out" at any time.

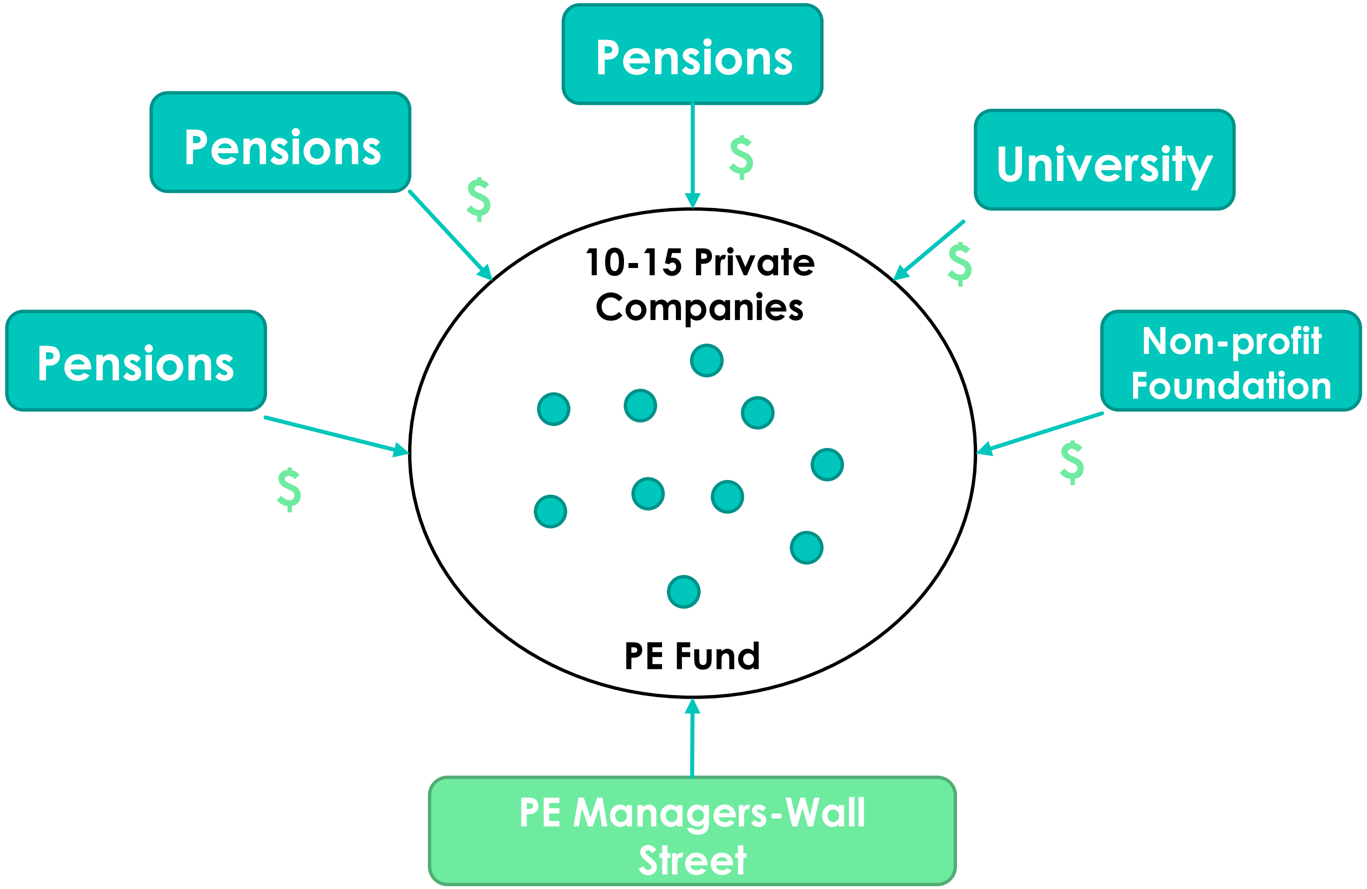
Private Equity Fund



Buys 10-15 private companies. Hopes to sell them by end of PE funds' 10-year life, for a profit. Fund investors "locked in" for 10 years. Most PE underperforms stock market.

What is Private Equity?

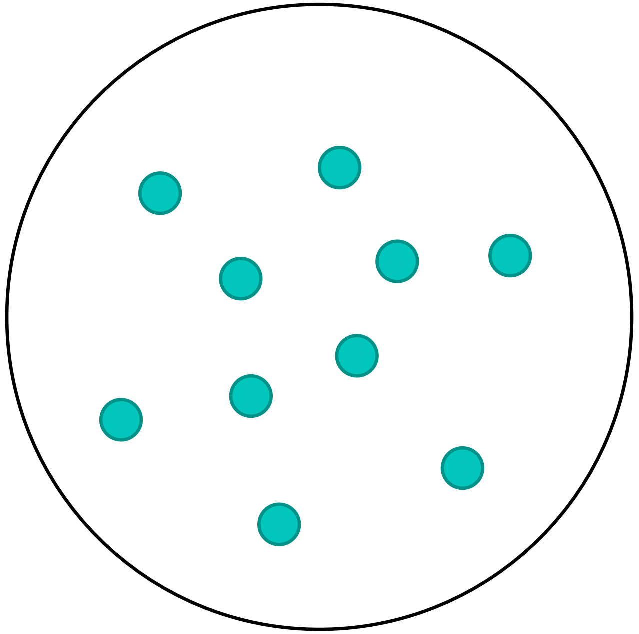
Big institutional investors, like state pension plans and university endowments, invest 97% of the money into a giant investment pool (PE managers, just 3%.)



PE fund managers—usually are former Wall Street professionals—choose which private companies to buy, and then sell, within 10-year PE fund life.

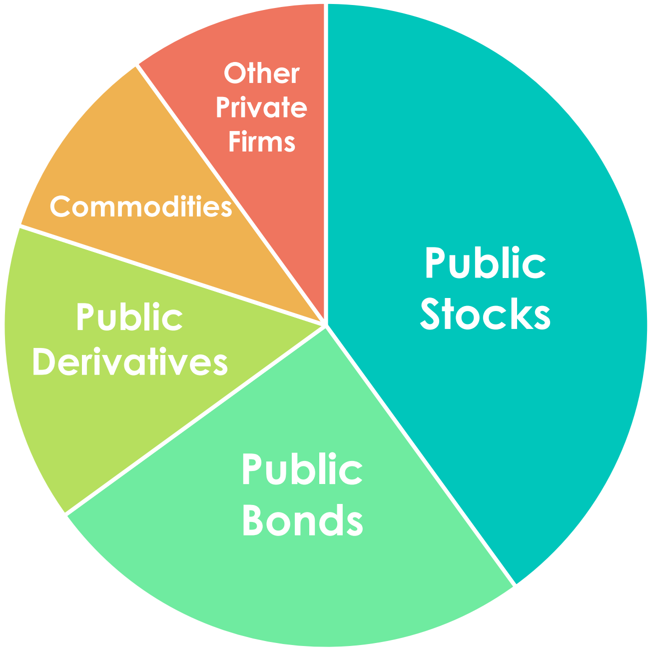
Difference Between PE Fund and Hedge Fund

Private Equity Fund



Buys and Sells Private Companies. Over 10-Year Life.
No Investor Redemption. Investors are "Locked In". Most PE Funds Don't Beat the Stock Market Returns.

Hedge Fund



Mostly Buys and Sells Publicly Traded Stocks and Bonds. Indefinite Life.
Investor Redemption Allowed Just One Time Per Year. Can't Beat Traditional 60% Stock/40% Index.

Private Equity Fund Managers Expanding Into Other Areas

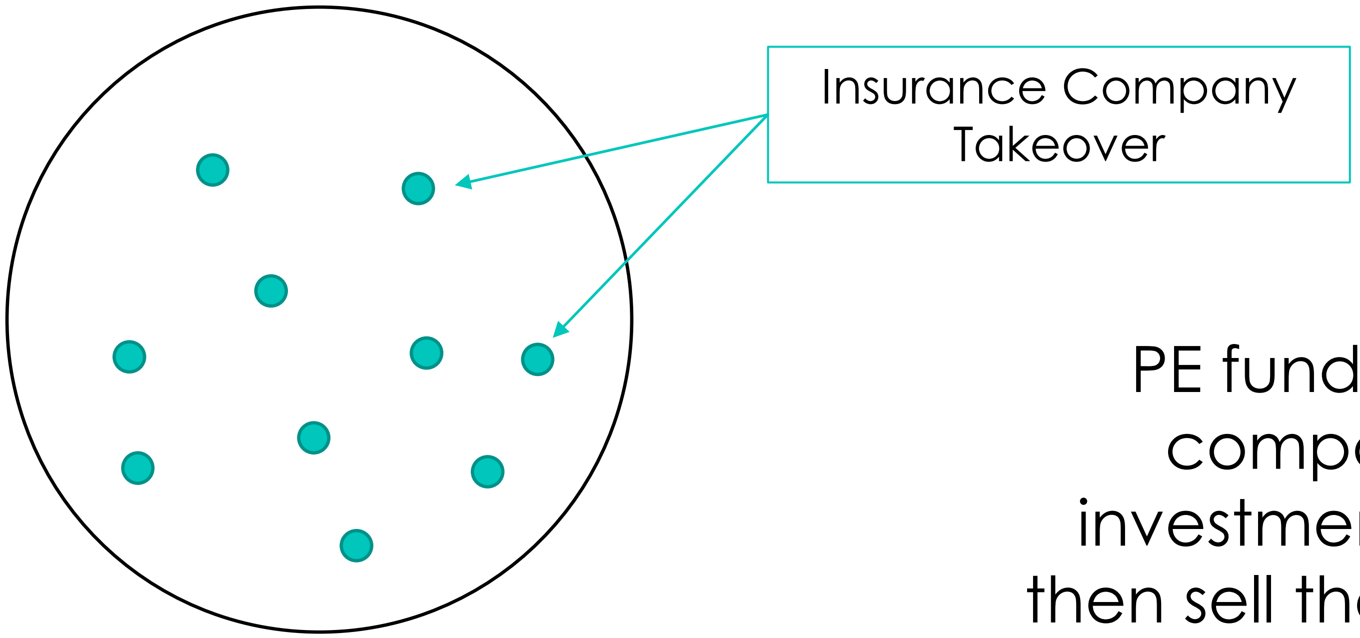
<u>Private Equity Fund Managers</u>

- Private Equity Funds
- Private Credit Funds—Lending $ to Private Companies
- Private Real Estate Funds

PE Going Into Insurance

Private Equity Funds Expanding Into the Insurance Industry— Method 1

Method 1



PE fund buys 1 or 2 insured companies as an equity investment. Hold for 5-6 years, then sell the insurance company.

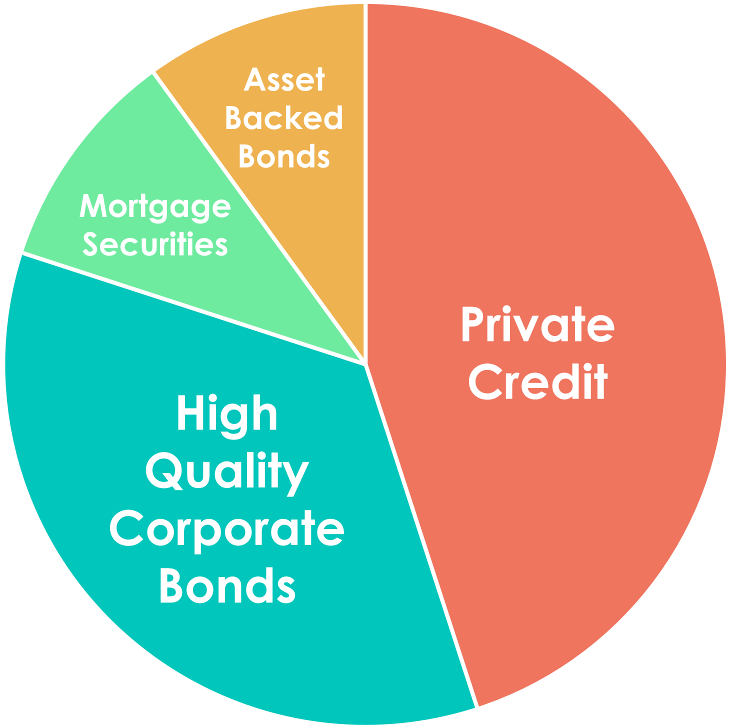
Method 1: Improvement Tactic

PE Fund "Owner" Tries to Improve Investment Return "Spread" Between Insurance Company Assets & Liabilities

Insurer Assets
Before PE Acquisition

Asset Return	5%
Liabilities Cost	-3%
Spread	+2%

Insurer Assets
After PE Acquisition



Asset Base Return	6%
Asset Losses	-1%
Liabilities Cost	-3%
Spread	+2%

Method 1: Improvement Tactic

PE Fund "Owner" Tries to Improve Investment Return "Spread" Between Insurance Company Assets & Liabilities

Insurer Assets
Before PE Acquisition

Insurance Company Assets Are Mostly High-Quality Corporate Bonds and Public Mortgage Securities. "Conservative, Liquid, Easy-to-Value"

Asset Return	5%
Liabilities Cost	-3%
Spread	+2%

Insurer Assets
After PE Acquisition

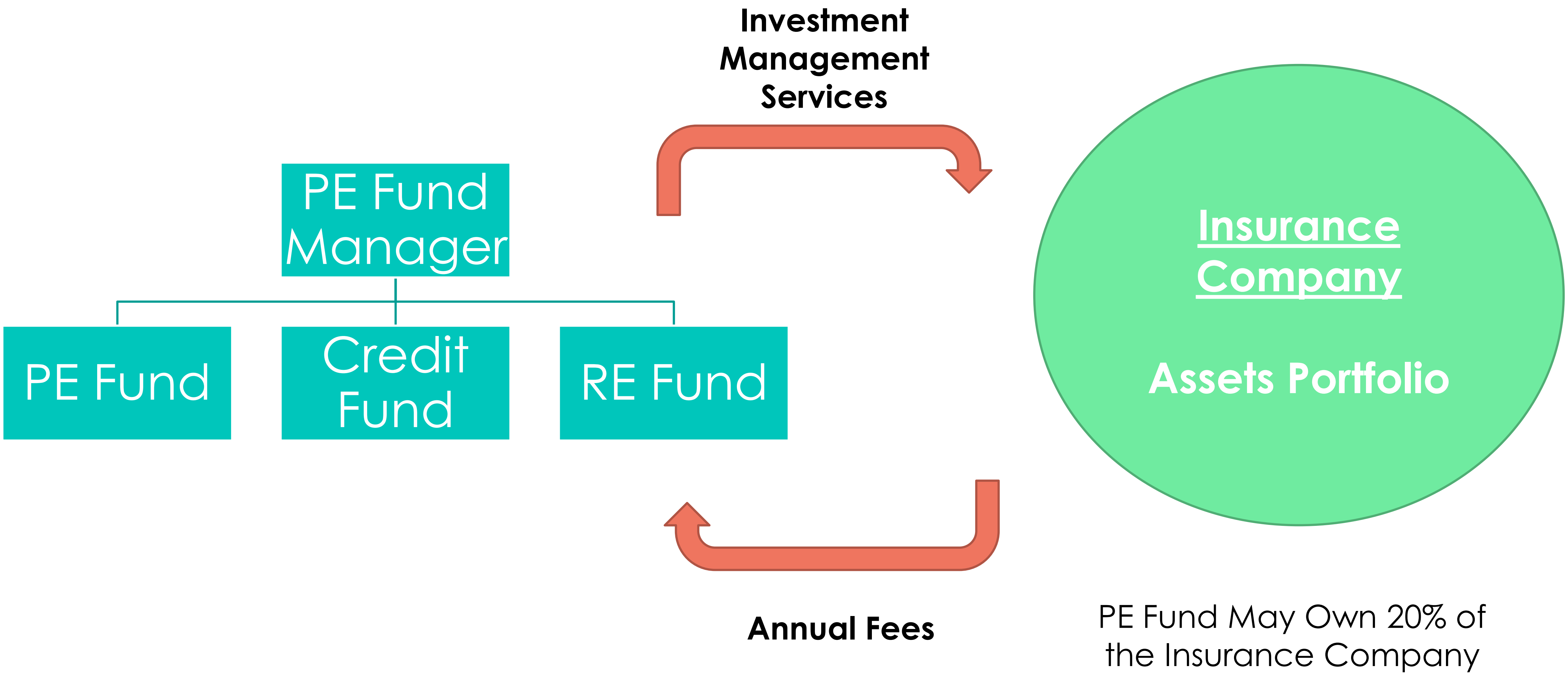
Still High Proportion of High-Quality Bonds. But, More Private Label and ABS Bonds. Less Conservative, Less Liquid, Harder to Value

Asset Base Return	6%
Asset Losses	-1%
Liabilities Cost	-3%
Spread	+2%

PE Going into Insurance: Method 2

Method 2: PE Doesn't Buy Insurance Company

Instead, PE Fund Manages Insurance Company Assets for Big Fees



Why Are Insurance Companies Highly Regulated by State Governments, like Banks Are Regulated by Federal Government?

- Political leaders and insurance policy holders want confidence that insurance companies to have money to:
  - Pay claims on policies.
  - Make annuity payments to savers.
  - Otherwise, we can have a financial panic, as policyholders start a ‘run’ on the insurer by ‘cashing out.’

Why Are Insurance Companies Highly Regulated by State Governments, like Banks Are Regulated by Federal Government?

- States often have “insurance company” backstops if insurance company can’t pay, like federal deposit insurance supports failing banks.
- States regulate insurers to try and verify insurance companies are conservatively managed.
- NAIC provides investment (or asset) quality oversight for many insurers, but slow and reactive.

Concerns with PE Involvement in Insurance Industry

- Short Time Horizon of PE
- More Mercenary Mindset of PE
- Fee Drain of PE
- PE Success at Secrecy at State and Federal Level

Insurance Regulators Concern

- <u>Shorter time horizon of PE funds</u>—PE tempted to cut corners to get good PE returns in 5-6 years.
- <u>More mercenary mindset of PE</u>—PE owners take more risks in insurance company asset portfolios than traditional insurance asset managers.
- <u>Fee drain on managed asset contracts</u>—Lack of fiduciary obligation. Little third-party oversight. High fees. The high fees can hurt annuity and policyholders, if asset returns are not good.
- <u>Secrecy</u>—PE industry is expert at keeping returns, fees, and ownership a secret from outsiders. Accounting auditors and regulators can't compete, or feel "outgunned".

"Inside Baseball"

- Most of this concern about PE and insurers is "inside baseball" in legislatures and in the financial community.
- Greg Lindberg, North Carolina, stuffed insurance companies with bad investments, but not classic PE.
- PE has managed to duck federal regulation the past 30 years.
- Closer state regulation might be an "uphill battle" as well, until a large PE-backed insurance company collapses.