Issue 6

January 2011

New York • London

Insurance Industry Focus
Freeman & Co. LLC

Is a Terrorist Lurking in Your Investment Portfolio?

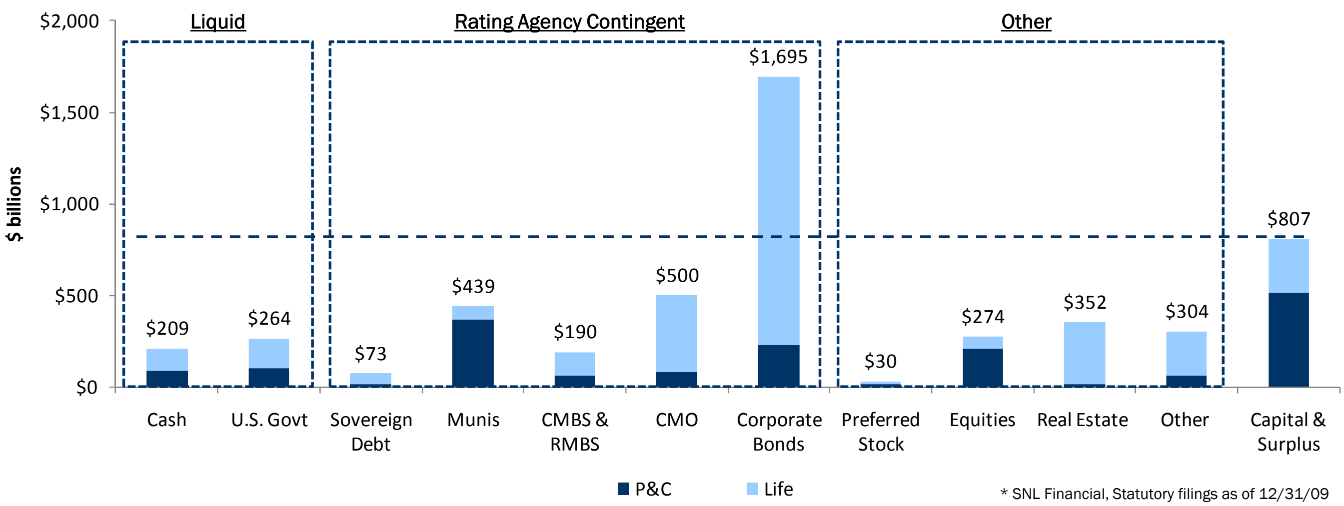
The U.S. insurance industry currently manages approximately $4.5 trillion in investment assets, across both the life and P&C sectors(1). Even though investment income represents a significant source of an insurance company's profits, the investment function of the business is often viewed as an afterthought. This is not necessarily the case for all insurance companies, but many companies take a startlingly passive approach to this aspect of the business and are merely concerned that the portfolio is compliant with the firm's 'investment parameters'. The investment parameters are adopted by the Board and reviewed annually, typically by the Board's Investment or Finance Committee. However, these parameters are often quite broadly defined, with minimum and average ratings requirements for the individual securities in the portfolio, which are typically fixed income securities, and general limitations on common equity and alternative investment concentrations. In addition, the investment function is often outsourced to third party investment managers that manage many other insurance company clients' assets.

At the Board level, it is common for directors and management to spend little time focused on the investment portfolio: as long as the portfolio is in compliance with the parameters, they can quickly move on to the next agenda item. Unfortunately, this passive approach to the investment portfolio can have serious consequences for an industry that views an "AA"-rated investment portfolio as largely risk-free or at least, low risk. We contend that this is far from the case. In fact, we believe the investment portfolios of insurance companies contain far more risk than ascribed by the conventional 'watchdogs' of the industry – regulators, rating agencies and sell side research analysts. Such unforeseen credit risks may result in an 'illiquidity contagion' within certain asset classes in a given investment portfolio.

We believe that the unforeseen risks in the typical "AA" average-rated portfolio are derived from three general areas:
(i) reliance on the rating agency oligopoly; (ii) sector concentration; and (iii) over-reliance on investment advisors.

(1) SNL Financial, Statutory Filings as of 9/30/10

P&C and Life Investment Assets Compared to Total Capital & Surplus



* SNL Financial, Statutory filings as of 12/31/09

Frank D. Lackner	Managing Director	+1 (212) 830-6189	flackner@freeman-co.com
Jimmy Chang	Associate	+1 (212) 830-6178	jchang@freeman-co.com
David Marciano	Analyst	+1 (212) 830-6172	dmarciano@freeman-co.com

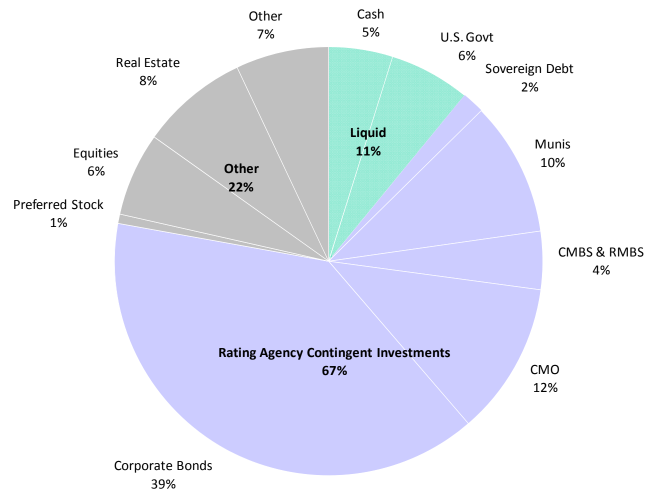
(i) Reliance On The Rating Agencies

Currently, the investment parameters of an insurance company typically require that the portfolio consist largely of fixed income securities and that the minimum rating of any security in the portfolio be investment grade, with an average rating across the fixed income sector of say, “AA” or “A+”. Fixed income securities will typically include U.S. Treasuries, sovereign country debt, municipal bonds and corporate-issued debt. Sometimes, this category may include preferred stock investments, but these take a higher capital charge given their ranking in the capital structure, even though they trade like bonds.

The unforeseen risk in this case is the broad reliance on the rating agencies. There appears to be a fundamental level of timing mismatch and general inaccuracies, often with an ‘after-the-fact’ approach to the downgrading process. During the recent (and we would contend, ongoing) liquidity and credit crisis, this mismatch could be seen over and over again with multiple major company examples: AIG, MBIA, Lehman, Citibank and WaMu. AIG, for example, maintained an “AA-” rating from S&P until 9/15/08, one day before being seized by the federal government. Citibank has maintained an “A” to “AA” rating throughout the past 24 months, even after being effectively bailed out by the U.S. government, if not to the extent of AIG. These are not small and obscure companies with thinly-traded publicly issued securities, but rather major institutions, that most traditionalists in the investment community would have considered ‘blue chip’ securities. From an insurance company investment parameters approach, investment portfolios are likely populated with many of these so-called blue chip bonds.

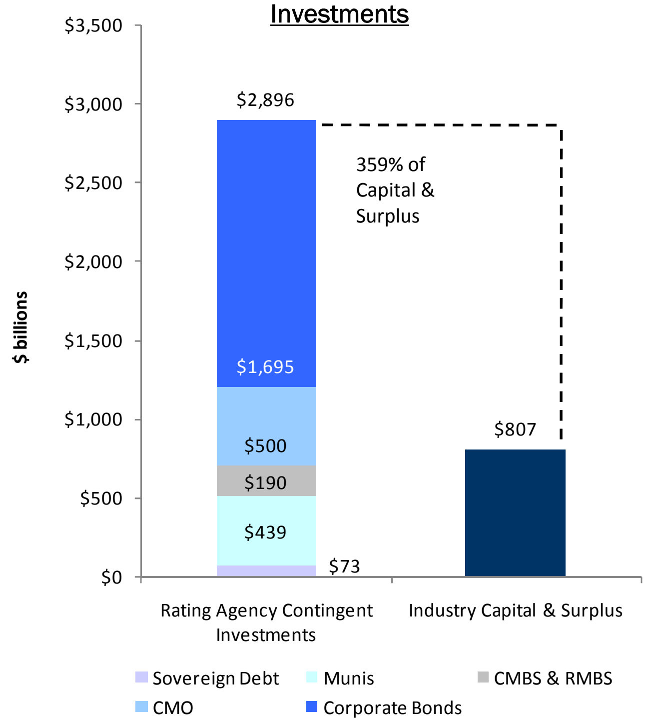
Notwithstanding the recent pandemic of global credit mispricing, insurance companies continue to invest with similar parameters. As a multiple of capital and surplus, i.e., the core equity of the industry that enables these companies to accept risk from their underwriting activities, the amount of rated fixed income securities that rely on these ratings represents a 3.6x multiple to capital and surplus. The chart to the right exhibits the magnitude of these securities as compared to total industry capital.

Investment Classes as a Percent of Total P&C and Life Invested Assets



Source: SNL Financial, Statutory filings as of 12/31/09

P&C and Life Exposure to Rating Agency Contingent Investments



Source: SNL Financial, Statutory filings as of 12/31/09

Select Rating Agency ‘Misses’ in 2008

Date	Firm	Event	Rating 1-Month Prior to Event[1]
3/24	Bear Stearns	Acquired by JPM for $1.5 bn	A+
7/11	IndyMac	Closed by regulators	B-
9/7	Fannie Mae	Seized by government	AAA
9/7	Freddie Mac	Seized by government	AAA
9/15	Merrill Lynch	Acquired by BofA for $50 bn	A+
9/15	Lehman Brothers	Declared bankruptcy	A+
9/16	AIG	Fed agreed to lend $85 bn	AA-
9/25	WaMu	Seized by FDIC. Assets sold to JPM	BBB
10/4	Wachovia	Acquired by Wells Fargo for $15.1 bn	A+
10/24	National City Corp	Acquired by PNC for $5.2 bn	A

1) Ratings from Fitch

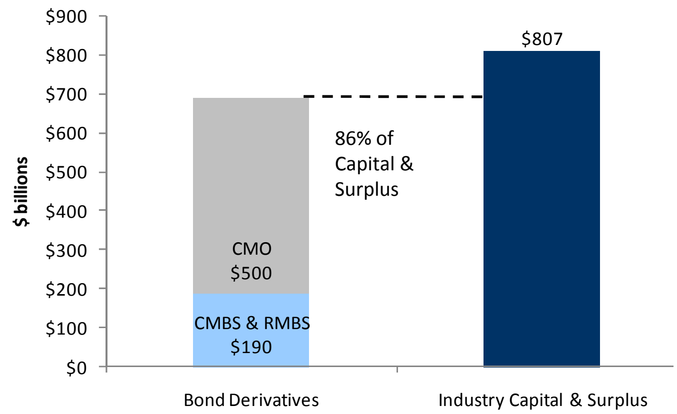
(ii) Sector Concentration Issue

Given the broad definitions for investment parameters, insurance companies often have large exposures to certain investment sectors and are, therefore, not aware of potential liquidity and valuation risks inherent in their portfolios. In our first example, we will focus on the category of financial services fixed income investments. Insurance companies had significant exposure to the financial services industry, which was perfectly fine as long as they met the average rating of "AA". The reality is that, given the interconnectivity in the financial services world, the credit quality of even the most senior of securities in this sector was far lower than "AA". In fact, many companies were close to default. In late 2007, a well-known third-party insurance asset manager told us that 'the entire financial services sector cannot default or just go away'. Although the eventual outcome was massive government intervention to save the sector, how can one take the position of being comfortable with a passively managed portfolio when knowing that its overall credit integrity was based on pure luck?

The second area of focus is in the category of asset-backed securities. This category includes any fixed income security whose value is derived from underlying asset values and cash flows derived therefrom. These asset-backed securities include CMBS, RMBS, CDOs and related securities. This remains an area of large concentration for the industry, notwithstanding the recent massive mispricing of credit risk in this category. As insurers continue to seek yield in a sharply declining interest rate environment, they have maintained or increased their exposure in this category.

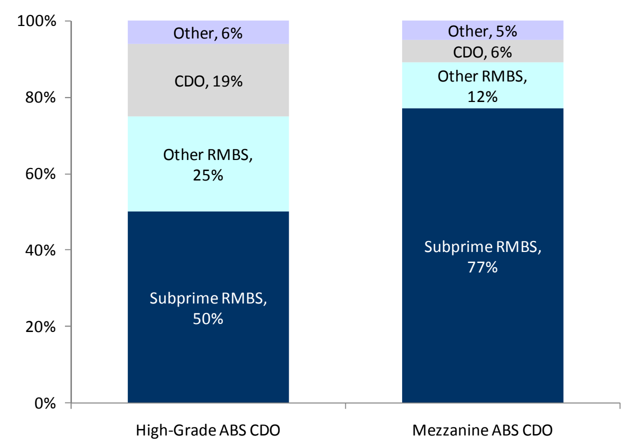
We believe that the underlying credit risk in this category far exceeds the actual risk implied by their ascribed ratings. In this case, the rating agencies are starkly conflicted from actually providing a more accurate estimate as to the securities comprising this category. This manifested itself somewhat over the past two years but is still a risk issue for this sector. Many of the defaults faced by the underlying securities and structures have not yet worked their way through the system, and as the rating agencies often rate both the underlying securities or assets as well as the main fixed income security, it would be very difficult to downgrade one without downgrading the other.

P&C and Life Exposure to Asset-backed Securities



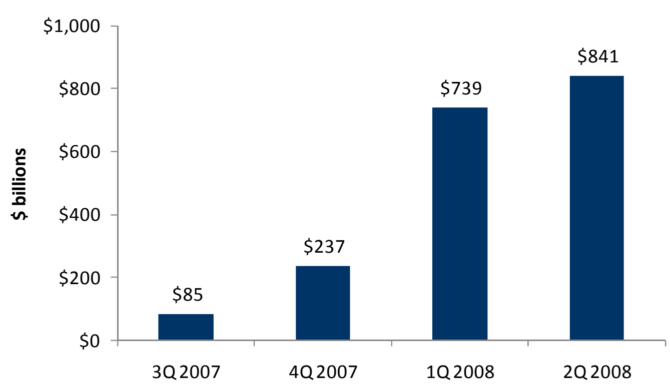
Source: SNL Financial, Statutory filings as of 12/31/09

Typical Collateral Composition of ABS CDOs



Source: Bank for International Settlements, July 2008

MBS Downgrades 2007 – 2008



Source: University of Iowa Center for International Finance and Development

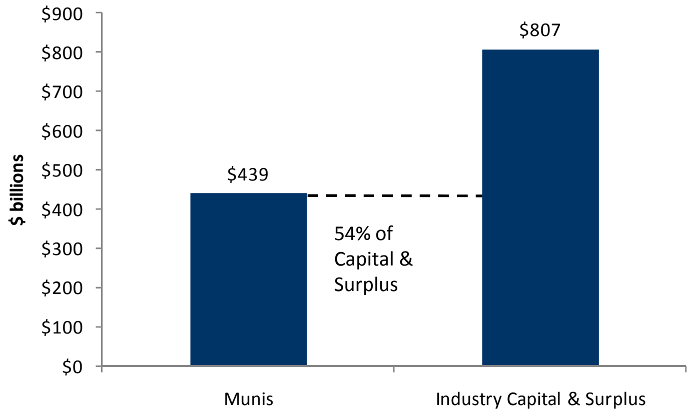
(ii) Sector Concentration Issues (cont'd)

The third area of focus is municipal bonds. As a by-product of seeking safe havens with decent yields, many insurers, particularly in the property & casualty sector, have begun to increase their allocation to municipal bonds. In fact, we are aware of several companies that have exposure to municipal bonds that is greater than their capital base. This is not to say that municipal bonds are all bad; quite the contrary. We do believe that certain municipalities' GOs and certain revenue bonds will be facing difficulties in the coming months or years for a variety of reasons. The GO bonds will be facing payment pressure due to the economic contraction, reducing its tax base as well as an erosion of cash flows due to massively underfunded pension liabilities and health care funds. Simply put, many public pension funds estimate their future payments using discount rates that are currently far too high, such as 8-9%. Finding investments with that yield in this environment is difficult in today's interest rate environment.

The political pressure to pay healthcare or pension payments to former municipal workers versus making interest payments on a bond held by large institutions may result in unforeseen decision-making on the part of local municipalities, particularly by councils that rely on their electorate in order to exist. Many revenue bonds will face lower cash flows due to a contracting economy. Local populations will be reducing their expenditures across the board, including regressively taxed items such as tolls and other items. Please refer to the chart on the right comparing muni investments and the industry capital base.

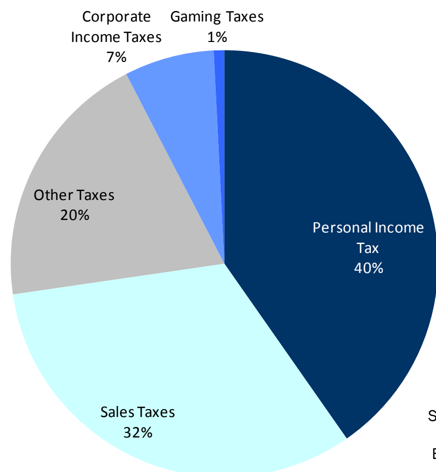
Because of the concentration issues in these three areas, we believe the industry has grossly underestimated the risks inherent in their investment portfolio and other areas that could have the potential for illiquidity contagion. The illiquidity contagion is a real risk that is not reflected in a security's rating. For example, at one point in late 2008, bids for financial services-related fixed income were virtually non-existent or extremely low. In fact, if the industry was required to mark its investment portfolio to market in November 2008 instead of at year-end December 2008, many companies would have faced a significant loss to their operating capital base, possibly as much as 50% or even higher. We believe that the illiquidity risk for these three aforementioned categories is real and could have a dramatic impact on the valuations of bonds within the industry's overall portfolio.

P&C and Life Exposure to Munis



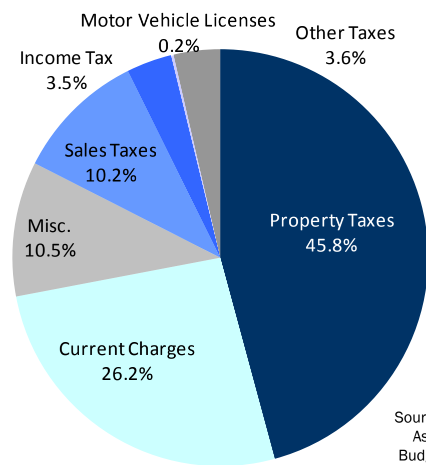
Source: SNL Financial, Statutory filings as of 12/31/09

Sources of Revenue at the State Level



Source: National Association of Budget Officers, 2009 State Expenditure Report

Sources of Revenue at the Local Government Level



Source: National Association of Budget Officers, 2008 State Expenditure Report

(iii) Passive Investing: Over-Relying on your Investment Advisor

Investment managers provide a valuable service to many insurance companies, including capital preservation, yield provision and financial reporting. For those companies that actively manage their own portfolios with in-house investment teams or that conduct their own independent credit analyses on the securities comprising the portfolio, this section would not pertain to you. However, many companies give full discretion to a third-party investment firm along with a broad set of investment parameters or guidelines. It is not to say that the investment firm has a separate agenda; in fact, the interests between firm and client are largely aligned. If the firm loses money or selects bad credits, they risk losing the client. We would add that the very nature of the fund management business is fungibility and allocation. Often, invested assets are pooled and then allocated to clients based on the provided parameters.

Insurance companies that entrust their assets to professional money managers can gain economies of scale by pooling with other insurance companies. In addition, money managers provide valuable services such as duration matching and accounting / reporting, thereby freeing up time for the CFO. Many smaller companies do not have the internal resources to thoroughly assess risk concentrations in their investment portfolio.

Conclusion

The insurance industry can no longer afford to be passive investors of their largest asset category. On the property & casualty side of the business, rates continue to soften, creating an even more competitive environment. On the life side, the hyper-competitive nature of the business continues to increase, and products that have embedded options, such as guaranteed minimum income benefits and minimum fund performance for linked products, will face increased pressure to achieve higher investment returns. In this still uncertain environment, companies need to be far more proactive with their investment portfolios and seek to identify ‘terrorist’ credit risks within. It is sensible to hire experts to parse through the investment portfolio and determine whether concentration or unforeseen credit risk issues exist that could cause large-scale sector illiquidity. Also, having multiple investment advisory firms ‘compete’ with each other on both yield enhancement and capital preservation is another way to ensure nothing is lurking around in the portfolio. As a percentage of the industry’s capital base, simply too much is at risk.

Select Freeman & Co. Insurance and Mortality-linked Transactions

$1,738,551,000
The Life Settlements and Premium Finance Portfolio of
KBC
has been acquired at auction
The undersigned acted as financial advisor to KBC Financial Products
April 28, 2010
Freeman & Co. Securities LLC

$840,000,000
The Reverse Mortgage Portfolio of
KBC
SENIOR LENDING NETWORK
has been acquired by an undisclosed
Investment Bank
The undersigned acted as financial advisor to KBC Financial Products
February 24, 2010
Freeman & Co. Securities LLC

700,000 policies administered
$30 billion in assets under administration
GUGGENHEIM
led investor group has acquired
se2
The undersigned acted as financial advisor to Security Benefit Corporation, parent of se2
February 16, 2010
Freeman & Co. Securities LLC

US $400 million investment
GUGGENHEIM
led investor group has acquired
SECURITY BENEFIT
The undersigned acted as financial advisor to Security Benefit Corporation
February 16, 2010
Freeman & Co. Securities LLC

$30,000,0000
Ullico
has completed a combined $30,000,000 senior debt and reinsurance transaction with
PATRIOT RISK MANAGEMENT INC
The undersigned acted as financial advisor to Ullico, Inc.
December 31, 2008
Freeman & Co. Securities LLC

KBC
has acquired
VERTICALLEND
The undersigned acted as financial advisor to KBC Financial Products
signed June 9, 2007
Freeman & Co. Securities LLC

KBC
has acquired the assets of
Mutual Credit Corp.
The undersigned acted as financial advisor to KBC Financial Products
November 13, 2006
Freeman & Co. Securities LLC

The Mortgage Loan and Real Estate Division of
CONNING
a wholly owned subsidiary of
Swiss Re
has been acquired by
KeyCorp
Acted as financial advisor to Swiss Re
June 28, 2002
Freeman & Co. Securities LLC