Capital Markets Special Report

The **NAIC's Capital Markets Bureau** monitors developments in the capital markets globally and analyzes their potential impact on the investment portfolios of U.S. insurance companies. A list of archived Capital Markets Bureau Special Reports is available via the **index**.

U.S. Insurance Industry Third-Party Investment Management

Overview

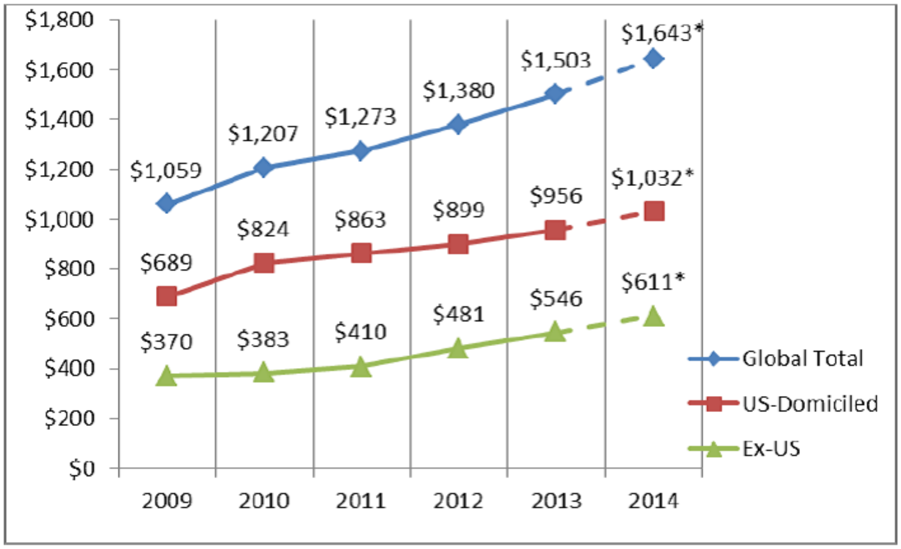
Since 2004, the cash and invested assets of U.S. insurers grew at an average of 4.7% per year to $5.5 trillion in book/adjusted carrying value (BACV) at year-end 2013. This growth trend was on pace to continue through 2014 based on net acquisitions reported for the first three quarters. Over the years, insurers have added to their fixed income allocations, such as in corporate bonds, commercial real estate and residential mortgage loans. Allocations to alternative assets in the form of private equity and hedge funds have also increased, particularly given the low interest rate environment.

The growth in assets and allocations to new asset classes over time has contributed to the rapid growth of outsourced third-party asset management in the insurance industry. The amount outsourced by U.S. insurers ranged between $1 trillion and $1.5 trillion, according to data from Moody's Investor Service and the Outsourcing Monitor, a trade publication monitoring outsourcing in the insurance industry, as of November 2014. Third-party (or outside) managers can provide asset class expertise that may not otherwise be available with in-house investment managers. Boston Consulting Group, a management consulting firm, reported that investment managers, as of year-end 2013, had about $68.7 trillion in total global assets under management (AUM). North America accounted for about $34 trillion of the total. Generally, insurers with cash and invested assets of $500 million or less were more likely to hire third-party managers than larger insurers because insurers with larger amounts of cash and invested assets have more resources available to develop the people and processes needed for appropriate in-house investment management.

Growth of External Investment Management

Outsourcing to external investment managers by U.S. insurers has increased since 2009 and is expected to increase further. The benefits to insurers, according to Moody's Investor Service, are: 1) asset managers with well-developed infrastructure and resources allow insurers to effectively implement new strategies and fine-tune tactical asset allocations in a shifting market; 2) small to medium-sized insurers may access investment opportunities that are otherwise not available; and 3) outsourcing generally costs less to implement compared to the cost of developing the expertise and infrastructure in-house.

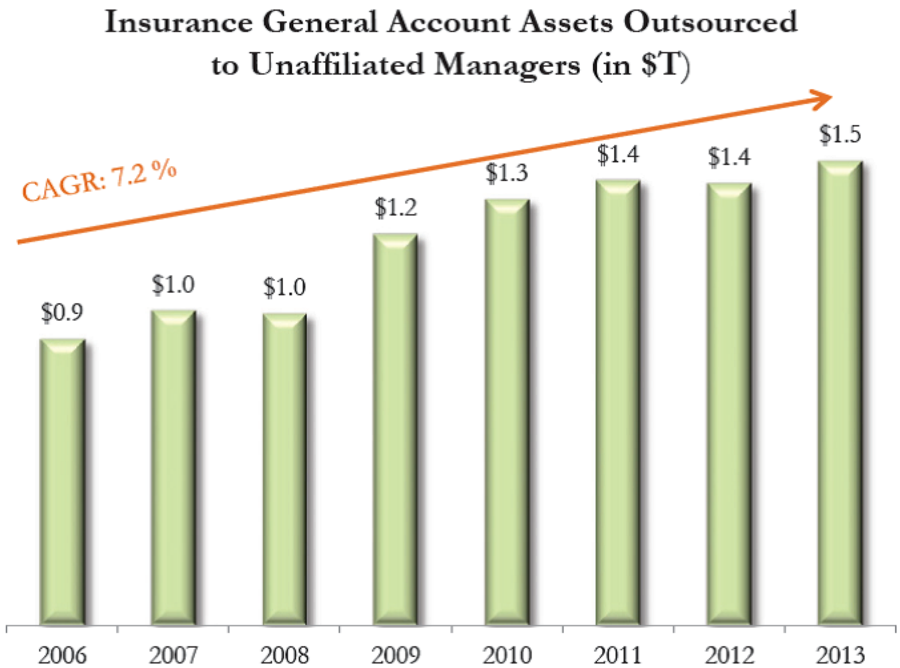
Chart 1: Historical Growth of Outsourced General Account Assets



Source: Outsourcing Monitor*. * 2014 year-end estimate is projected from June 2014 manager-reported assets under management (AUM) from The Insurance Investment Outsourcing Report 2014, published jointly by the Insurance Asset Outsourcing Exchange, Insurance AUM and Insurer AM. 2009-2013 year-end estimates from IAM Annual Surveys and Insurance Investment Outsourcing Report, adjusted for non-participants in those surveys. In 2013, insurers outsourced about 16.5% of general account assets for investment management. That percentage is forecasted to increase to about 20%, or about $1.4 trillion, by 2019, according to the* Outsourcing Monitor*.*

The NAIC Capital Markets Bureau special report titled "Insurance Asset Management: Internal, External or Both?" published Aug. 26, 2011, outlined many of the reasons for use of an external asset manager. Reasons included the need for specialized knowledge and systems, investment and sector experience across the spectrum of fixed-income products. Without a sufficiently large amount of cash and invested assets, formation of an internal investment management team may have a negative impact on performance in the short term. An investment team with no prior experience in an asset class requires time to learn the asset as well as the drivers of value in that asset class. The 2011 report states, "Without that size, the investment manager's operation would be inherently limited in breadth and depth. The internal manager would not be able to economically offer a broad range of investment capabilities covering a wide variety of asset classes." This is also true today, especially given the expansion of available investment options.

Chart 2:

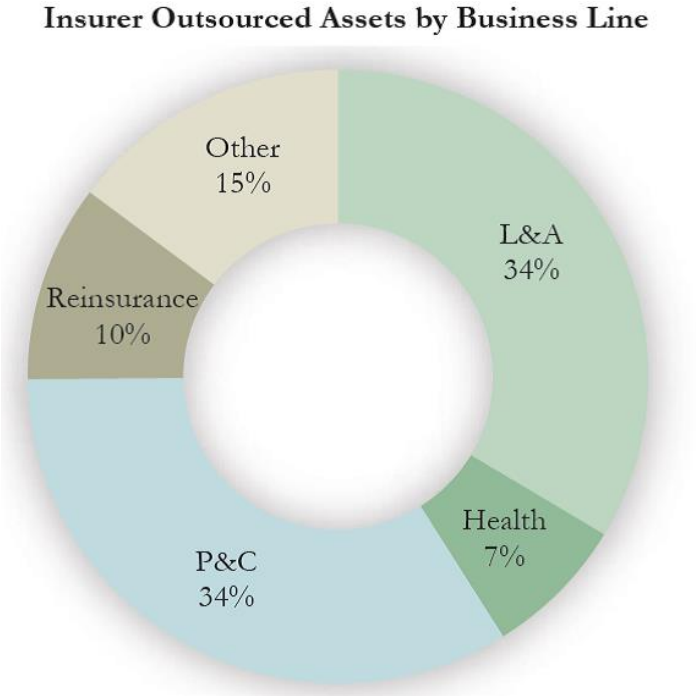


Source: 2014 Insurance Asset Manager Survey, Patpatia & Associates Inc. CAGR is compound annual growth rate.

Investment management outsourcing does not always entail outsourcing an insurer's entire portfolio. Insurers may engage a manager for a specific asset class or type, such as residential mortgage-backed securities (RMBS), for example. Since the 2008 financial crisis, available credit support has increased in non-agency RMBS transactions. This does not eliminate the complexity of the security. Nuances in priority of payment or other transaction features, which may seem minor, could have major effects on performance. Insurers may not have staff that is experienced, for example, in RMBS cash flow modeling. Staff may also not be familiar with the RMBS industry's standard originator representations and warranties, which serve to protect investors. These nuanced differences also exist across the alternative investment universe. For this reason, outside investment managers dealing in the specific market for an investment security is more efficient than developing internal expertise. Insurers are then better able to monitor performance and impending risks.

According to the 2014 Insurance Asset Manager Survey by Patpatia & Associates Inc. (2014 Patpatia Survey), life and P/C insurers accounted for 68%, or 34% each, of outsourcing by insurers (as shown in Chart 3). The survey points to a "middle market" of insurance companies with assets from $5 billion to $25 billion, comprising the largest share of outsourced assets in 2013.

Chart 3:



Source: 2014 Insurance Asset Manager Survey, Patpatia & Associates Inc.

U.S. Insurance Industry Outsourced Investment Management

An analysis of year-end 2013 NAIC data showed that about 1,197 insurers disclosed use of a third-party asset manager. P/C insurers were 54.6% of the total, or 653 in number, with life insurers at 22.3%, or 267. Health insurers accounted for 19.8%, followed by fraternal at 2.1% and title at 1.3%.

In terms of the third-party investment managers, Gen Re-New England Asset Management Inc. tops the list with the largest number of mandates from U.S. insurers at 47, followed by Asset Allocation & Management Company, LLC (41) and BlackRock Inc. (40) to round out the top three as of year-end 2013.

Table 1:

Investment Manager	No. of Mandates*
Gen Re-New England Asset Management Inc.	47
Asset Allocation & Management Company, LLC	41
BlackRock, Inc.	40
Conning and Company	31
Deutsche Investment Management Americas Inc.	23
Wellington Management Company	23
J.P. Morgan Investment Management	22
Goldman Sachs Asset Management	19
Bank of America Merrill Lynch Wealth Management	15
Prime Advisors Inc.	13

**Financial statement disclosure does not include the dollar value under mandate.*

Though BlackRock Inc., based on the number of insurer mandates, is third on the top-10 list above, it tops the 2014 Patpatia Survey with $207.8 billion in third-party insurer general accounts managed, as shown in Chart 4.

Chart 4:

North American & Global Insurance Asset Manager Survey Participants (US$ in B)

Rank	Asset Manager	Third-Party GA	Affiliated	Sub-Advised	Total Ins.	Total AUM
1	BlackRock, Inc. *New York, NY: Multi-asset solutions*	**207.8**	0	119.3	327.1	4,324.1
2	Deutsche Asset Management *New York, NY: Fixed income and equity with alternatives, particularly real estate*	**196.3**	5.0	0	201.3	893.6
3	Goldman Sachs Asset Management *New York, NY: Fixed income with alternatives, including private equity and hedge funds*	**91.7**	0	54.9	146.5	905.4
4	Pacific Investment Management Co. *Newport Beach, CA: Broad fixed income offerings*	**86.5**	390.6	118.3	595.4	1,535.1
5	Wellington Management Company, LLP *Boston, MA: Balanced fixed income and equity*	**85.7**	0	60.7	146.4	834.4
6	Delaware Investments *Philadelphia, PA: Fixed income with equity boutiques*	**81.5**	0	0	81.5	187.2
7	Conning Asset Management *Hartford, CT: Dedicated insurance asset manager*	**79.5**	0	0	79.5	83.4
8	GR-NEAM *Farmington, CT: Dedicated insurance asset manager*	**61.2**	29.0	0	90.2	91.2
9	J.P. Morgan Asset Management *New York, NY: Fixed income with alternatives, including real estate and private equity*	**60.5**	0.5	40.9	101.8	1,598.1
10	Western Asset Management Co. *Pasadena, CA: Fixed income with equity*	**48.5**	0	19.5	68.0	451.6

Source: 2014 Insurance Asset Manager Survey, Patpatia & Associates Inc.

NAIC Regulatory Guidance

The Financial Condition Examiners Handbook (Handbook) provides clear guidance on assessing the risks associated with the key activities of an insurer. One of those activities is investment management, which has been increasingly contracted to a third party through an investment agreement. An investment agreement provides guidelines under which an investment manager may invest on behalf of an investor. Investment guidelines typically stipulate limits on any single security or industry concentration. Use of outside managers does not relieve the insurer's management (and board of directors) of responsibility for compliance with statutory accounting rules and regulations.

To assess whether assets are managed according to relevant regulations and the investment agreement, the Handbook advises examiners to:

"Review procedures that ensure management reviews the credentials of the third party and that no conflict of interest exists."

"Review the insurer control to ensure third-party contract disclaimers of responsibilities and termination are reasonable."

"Review a sample of material outsourcing arrangements for evidence of management review of vendor performance."

"Review internal audit reports providing evidence that the insurer reviews third-party performance, position relative to guidelines, risk assumed, turnover and gains stripping (i.e., gains realized in line with guidelines and objectives)."

"Determine whether the company has implemented controls over affiliate agreements to ensure that they are approved by regulators as required."

The guidance provides a high-level focus on insurer oversight of the outside manager. The list of managers from the 2014 Patpatia Survey includes well-known, reputable managers with large sums under management and, therefore, provides comfort with the current process included in the Handbook. As new asset classes or investment vehicles are created, and/or new managers enter the field, an enhanced process may be prudent. In addition, greater diligence in monitoring compliance with the insurer's investment policy will be required.

The enhanced process may include the examination team's review of the results from due diligence conducted by the insurer and/or review of results from the manager's external auditor. A focus on affiliated transactions is critical, particularly with the recent increase in nontraditional owners (i.e., private equity firms) of regulated insurers.

Affiliated transactions should be reviewed to check that they were conducted at an arms-length basis or on the open market. This applies to affiliated transactions where an outside manager transacts with a related company on behalf of an insurer, or where an investment manager parent company (such as a private equity firm) of the insurer transacts with the insurer. An example of this scenario would be where a private equity parent buys the securities of a company it owns (or controls) on behalf of the insurer. Insurance subsidiaries investing in funds managed by a private equity parent must be mindful, as with all private equity fund investors, that fund transactions are conducted on the open-market in arms-length transactions. Valuation of fund holdings should comply with the market standard of fair value. Generally, prices paid or received from a transaction conducted in the open market or on an arms-length basis are expected to be a fair market price. When an outside manager transacts with an affiliated party, any price obtained from such transaction should be equal to the price that would have been obtained if conducted on the open market or at arms-length.

Anecdotal evidence from Eager, Davis & Holmes (a consulting firm focused on advising investment managers that primarily manage assets for insurers) and other similar market participants suggests that as asset manager interest in managing insurer assets has increased, downward pressure on fees has also increased. The downward pressure is more evident for mandates on U.S. bond and other liquid assets. Generally, investment management agreements provide for a base management fee as a percentage of assets managed. Some agreements provide for a decreasing percentage to a minimum percentage as AUM increase. Performance incentives are fees paid to managers for achieving an agreed upon rate of return or other measure. Incentive fees are customary with private equity and hedge funds. Management fees should be in line with those paid by other insurers to unaffiliated managers. Fees and expense associated with a simple bond portfolio versus fees for emerging market or other complicated asset will be different. A point of reference for assessing investment management fees is a comparison to fees on indexed mutual funds, mutual funds, or exchange-traded funds (ETFs) of similar assets.

Conflict of interest is rooted in any concern about affiliated transactions and the amount of fees paid by insurers, especially where the manager is an affiliated manager. Fee layering, where a manager is in effect paid twice for investment management services, should be an issue of concern to the extent it is not addressed in investment agreements. Fee layering occurs when the primary manager hires affiliated sub-managers or places an insurers assets in a vehicle affiliated with the primary manager.

Purchases that conflict with the investment strategy of other managed accounts, including other insurers, are another example of a potential conflict of interest. Addressing this issue requires more than a high level review of management oversight by insurers. As the universe of outside managers expands to lesser known investment managers, an increased level of due diligence of these service providers may be warranted.

Insufficient (or inexperienced) staff at small or new investment management firms may raise concerns about the firm's ability to execute and profit in a given asset class. Sufficient and experienced staff—both analytical and administrative—allow for the creation of repeatable investment processes that flow from idea generation through to trade execution. The investment process must include checks and balances, which prevents any single individual from acting outside the knowledge of others. In addition, quantitative strategies are generally computer-driven, and, therefore, prudent investment management resources would include sufficient allocations to IT infrastructure for model development and maintenance. While the insurance industry still is largely buy and hold, or at least less actively managed—versus total return mandates—aggressive portfolio management (as typified by most quantitative strategies) is not well suited for managing insurer investment portfolios.

Conclusion

The 2014 Patpatia Survey, among other sources, provides evidence that insurer use of outside managers for portfolio management is expanding. The top-10 managers currently utilized are among the largest investment managers in the respective industry. With continued growth in insurer use of third-party investment managers, greater emphasis on the due diligence process and internal control procedures will likely be necessary. The NAIC is working on formulating guidance on examination procedures for the review of investment management agreements and insurer investment policy.

The Capital Markets Bureau will continue monitoring the U.S. insurance industry's outsourcing of investment management and report any developments deemed appropriate.

May 1, 2015 Major Insurer Share Prices		Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Life	Aflac	$63.18	(1.6)	(1.3)	3.4	$64.19	$64.01	$61.09
	Ameriprise	125.16	(2.0)	(4.3)	(5.4)	127.75	130.84	132.25
	Genworth	9.07	15.4	24.1	6.7	7.86	7.31	8.50
	Lincoln	57.43	0.2	(0.1)	(0.4)	57.32	57.46	57.67
	MetLife	52.06	2.8	3.0	(3.7)	50.66	50.55	54.09
	Principal	51.53	(0.2)	0.3	(0.8)	51.62	51.37	51.94
	Prudential	83.24	3.0	3.6	(8.0)	80.79	80.31	90.46
	UNUM	34.42	2.2	2.0	(1.3)	33.68	33.73	34.88
PC	ACE	$107.59	(0.8)	(3.5)	(6.3)	$108.51	$111.49	$114.88
	Axis Capital	52.38	2.3	1.6	2.5	51.20	51.58	51.09
	Allstate	69.95	(1.4)	(1.7)	(0.4)	70.95	71.17	70.25
	Arch Capital	61.27	0.0	(0.5)	3.7	61.24	61.60	59.10
	Cincinnati	50.70	(3.5)	(4.8)	(2.2)	52.56	53.28	51.83
	Chubb	99.04	(1.4)	(2.0)	(4.3)	100.41	101.10	103.47
	Everest Re	180.23	(1.1)	3.6	5.8	182.29	174.00	170.30
	Progressive	26.94	0.3	(1.0)	(0.2)	26.86	27.20	26.99
	Travelers	101.95	(1.9)	(5.7)	(3.7)	103.95	108.13	105.85
	WR Berkley	49.16	(1.2)	(2.7)	(4.1)	49.76	50.51	51.26
	XL	37.03	(2.0)	0.6	7.7	37.79	36.80	34.37
Other	AON	$98.22	0.4	2.2	3.6	$97.84	$96.12	$94.83
	AIG	57.84	1.5	5.6	3.3	56.99	54.79	56.01
	Assurant	61.89	3.0	0.8	(9.6)	60.09	61.41	68.43
	Fidelity National	35.95	(6.0)	(2.2)	4.4	38.25	36.76	34.45
	Hartford	41.08	(1.8)	(1.8)	(1.5)	41.84	41.82	41.69
	Marsh	56.42	(0.9)	0.6	(1.4)	56.96	56.09	57.24
Health	Aetna	$108.09	(0.7)	1.5	21.7	$108.82	$106.53	$88.83
	Cigna	125.02	(4.3)	(3.4)	21.5	130.66	129.44	102.91
	Humana	165.91	(9.0)	(6.8)	15.5	182.35	178.02	143.63
	United	113.26	(4.6)	(4.3)	12.0	118.69	118.29	101.09
Monoline	Assured	$25.99	(4.3)	(1.5)	0.0	$27.16	$26.39	$25.99
	MBIA	8.71	(4.3)	(6.3)	(8.7)	9.10	9.30	9.54
	MGIC	10.33	(4.2)	7.3	10.8	10.78	9.63	9.32
	Radian	17.61	(4.1)	4.9	5.3	18.37	16.79	16.72
	XL Capital	37.03	(2.0)	0.6	7.7	37.79	36.80	34.37

May 1, 2015 Major Market Variables		Close	Change % Week	Change % QTD	Change % YTD	Prior Week	Prior Quarter	Prior Year
Dow Jones Ind		18,002.88	(0.4)	1.3	1.0	18,080.14	17,776.12	17,823.07
S&P 500		2,104.15	(0.6)	1.8	2.2	2,117.69	2,067.89	2,058.90
S&P Financial		327.65	0.3	0.8	(1.7)	326.66	324.95	333.32
S&P Insurance		303.15	0.4	0.9	(1.3)	302.04	300.59	307.04
US Dollar $			Change %			Prior		
	/ Euro	$1.12	3.1	4.5	(7.4)	$1.09	$1.07	$1.21
	/ Crude Oil bbl	59.29	3.7	24.6	10.1	57.19	47.60	53.83
	/ Gold oz	1,174.40	(0.1)	(0.7)	(0.7)	1,175.20	1,183.10	1,182.10
Treasury Ylds %		%	Change bp			%	%	%
	1 Year	0.23	0.02	(0.03)	0.02	0.21	0.26	0.22
	10 Year	2.11	0.20	0.19	(0.06)	1.91	1.93	2.17
	30 Year	2.82	0.21	0.29	0.07	2.61	2.54	2.75
Corp Credit Spreads -bp			Change %			Prior		
	CDX.IG	9.27	2.6	(10.4)	(20.7)	9.04	10.35	11.69

May 1, 2015

Major Insurer Bond Yields

				Weekly Change					YTD
				Price			Spread over UST		Spread
	Company	Coupon	Maturity	Current	Change	Yield	B.P.	Change	Change
Life	Ameriprise	5.300%	3/15/2020	$114.63	($0.81)	2.11%	63	(2)	(12)
	Genworth	6.515%	5/15/2018	$105.38	$0.13	4.60%	354	(17)	(83)
	Lincoln National	8.750%	7/15/2019	$124.80	($1.25)	2.43%	105	5	(10)
	MassMutual	8.875%	6/15/2039	$156.88	($4.30)	4.85%	221	0	26
	MetLife	4.750%	2/15/2021	$112.76	($1.11)	2.37%	68	0	(8)
	New York Life	6.750%	11/15/2039	$138.84	($3.37)	4.20%	154	(4)	(1)
	Northwestern Mutual	6.063%	3/15/2040	$127.26	($4.50)	4.27%	158	3	9
	Pacific Life	9.250%	6/15/2039	$155.49	($2.38)	5.19%	255	(8)	10
	Principal	6.050%	10/15/2036	$120.33	($4.95)	4.55%	201	15	26
	Prudential	4.500%	11/15/2020	$110.48	($1.08)	2.46%	81	(0)	(18)
	TIAA	6.850%	12/15/2039	$134.82	($1.79)	4.50%	185	(9)	18
P&C	ACE INA	5.900%	6/15/2019	$114.58	($0.74)	2.17%	83	(1)	(1)
	Allstate	7.450%	5/15/2019	$120.35	($0.90)	2.15%	81	2	(4)
	American Financial	9.875%	6/15/2019	$126.85	($0.96)	2.89%	153	4	8
	Berkshire Hathaway	5.400%	5/15/2018	$112.08	($0.53)	1.31%	31	2	(10)
	Travelers	3.900%	11/15/2020	$108.73	($0.88)	2.20%	58	(2)	(3)
	XL Group	6.250%	5/15/2027	$120.49	($2.14)	4.08%	176	2	(7)
Other	AON	5.000%	9/15/2020	$111.87	($0.75)	2.63%	100	(5)	4
	AIG	5.850%	1/15/2018	$111.25	($0.51)	1.57%	69	4	1
	Hartford	5.500%	3/15/2020	$114.07	($0.41)	2.43%	90	(9)	(10)
	Nationwide	9.375%	8/15/2039	$158.53	$0.11	5.13%	249	(22)	2
Health	Aetna	3.950%	9/15/2020	$108.18	($0.92)	2.31%	66	(1)	(27)
	CIGNA	5.125%	6/15/2020	$113.59	($1.02)	2.29%	69	0	(25)
	United Healthcare	3.875%	10/15/2020	$108.53	($1.06)	2.20%	51	1	(13)
	Wellpoint	4.350%	8/15/2020	$109.80	($1.18)	2.36%	76	3	(16)

Questions and comments are always welcomed. Please contact the Capital Markets Bureau at **CapitalMarkets@naic.org**

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