INVESTMENT ADVISOR-OWNED INSURERS
A Proposal for Avoiding Pitfalls and Realizing Benefits

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SYNOPSIS

An important trend is taking place in financial services: the formation of Advisor-As-Owner (AAO) insurance entities. This corporate form has critical governance and regulatory implications centered on conflict of interests. As a result of these implications and the complex jurisdictional fabric of insurance and advisory regulation, the growth of AAOs has drawn the attention of multiple regulatory bodies. These organizations are in various stages of forming policy responses. Our discussions with senior industry leaders confirm that the potential business benefits enabled by the AAO model are closely aligned with the governance and risk controls (both operational and portfolio related) essential to its implementation. Our goal with this paper is to make recommendations on these AAO-related governance policies and management practices, many of which also apply to non-AAO insurers investing in alternatives.

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THE INTERSECTION OF INSURERS' SEARCH FOR RETURNS AND INVESTMENT ADVISORS' SEARCH FOR GROWTH

There has been widespread reporting[1] on an important development in the insurance industry: Alternative investment advisors having control or significant influence over long-tail underwriters while also providing investment advisory services to these entities. **We refer to this business model as Advisor-As-Owner (AAO).** How far we've come from these two groups having space between themselves for many years (with notable exceptions among large insurers)![2] In this paper, we will focus on how AAOs shape governance and investment management, starting with a brief explanation of the changing conditions that lead to their formation.

AAOs represent a significant industry manifestation of two related but independent trends accelerating over the last few years. First, insurers have made much larger allocations to "alternative" investments in response to persistently low yields. Second is the evolution of how to secure the associated investment management expertise. Initial means included recruiting staff or elective outsourcing to third-party advisors, in some cases sister companies in a non-operating holding company or equivalent.

Before going further, we emphasize that "alternatives" is not informative beyond answering…*alternative to what?*…namely conventional equities and fixed income.[3] Sources of risk premia include various combinations of illiquidity, cash flow uncertainty, complexity, opacity, leverage/derivatives, and creditworthiness. While product subcategories narrow things down in some respects (time horizon, tax treatment, fee structures, investment vehicle), substantial variation exists between and within categories in risk profile and other investment properties. The risks and attributes of some alternatives like traditional private equity/venture capital are well understood from a long record. The investment profile of newer strategies, like structured credit, including private credit or asset backed, is still in the formative stage.[4]

More recent "outsourcing" of alternatives within AAOs has put the conflict-of-interest elephant in the governance room. Shifting ownership and control trends have gotten the attention of congress, the NAIC, and other rulemaking bodies, including the Treasury Federal Insurance Office and Bermuda Monetary Authority. In recent years the NAIC and state regulators have heightened disclosure requirements for affiliated, controlling, and related parties and continue to initiate programs that will allow them to gain additional transparency on transactions that involve potential conflicts of interest.

An AAO, like all advisors, seeks growth in assets under management subject to higher fees and lower account turnover. Insurance companies also prefer longer relationships but are more conservative and fee-conscious investors. We will answer two questions.

1. What mutual motivations lead to the establishment of AAOs which, on the surface, appears counterintuitive and certainly a change from financial services' history?
2. How can the AAO model move forward with positive expectations for all parties?

While often rooted in a valid business strategy, parent/affiliate and related party transactions also have a checkered past. With an AAO, there is an intuitive, if not preferred, rationale for this arrangement in concept. An owner with solid capabilities in alternatives can be a *significant* competitive advantage for an insurance company and benefit all stakeholders.

1 *Private Equity Taps Insurers' Cash to Speed Up Growth;* THE WALL STREET JOURNAL; January 31, 2023; Wirz, Scism.

2 See *Insurance Investment Outsourcing Report*, 2022 EDITION; Published by INSURANCE ASSET Outsourcing Exchange in Partnership with CLEARWATER ANALYTICS.

At year end 2021, insurers held over $500 billion in alternatives, almost twice as much as 10 years ago, with hedge funds, private equity and real estate accounting for approximately 75%; NAIC U.S. Insurance Industry's Exposure to Schedule BA. PE-backed companies accounted for $472 billion in adjusted asset carrying value at year end 2021; NAIC PE-Owned U.S. Insurers.

3 We define "alternatives" for this paper as hedge funds, structured investments, real estate, infrastructure investments, and all levels in the capital structure distributed through private markets.

4 While collateralized loan obligations (CLOs) and other structured assets that are increasingly popular with insurers have been around for over 30 years, the market has grown and evolved substantially since the Great Financial Crisis, often making it difficult to draw inference from risks observed historically.

In addition to the advisor's investment performance, realizing a positive outcome depends on the implementation of specific governance policies and integration practices. When doing so, there can be reasoned expectations that the insurer's investment performance, risk management, and cost efficiencies will accompany their advisor-owner's long-term growth in assets under management.

There is an infinite number of possible corporate forms comprised of multiple layers and entities, each with its own set of stakeholders that can reach a byzantine state. Nevertheless, the recommendations below constitute an effective AAO game plan that transcends the type of alternative strategy, enterprise architecture, and form of ownership, and anticipates a possible monetization of the AAO entity. Several of these principles, whether or not required by current regulation or statute, are effective for even the hypothetical single-parent captive, wholly owned by an investment advisor (the less-regulated "sole constituent" case). Widely adopted, including non-AAO insurers, they would help prevent corporate failure and follow-on disruption in the risk-transfer ecosystem, such as state guaranty fund triggers and general instability.

WHERE DID THIS START? – LOW YIELDS CULTIVATE A SEARCH FOR ALTERNATIVE SOURCES OF RETURN

This is the easier question. Before the current phase of rising interest rates, many insurers' sought returns higher than those available through more conventional strategies. This need, coupled with maturity in traditional investor segments targeted by specialty advisors, has created a better fit in the eyes of many. Funding dynamics solidified this fit. The withdrawal by banks following the Great Financial Crisis redirected alternatives funding to insurers showing greater interest in these investments. Also, managers' access to insurers' less-liquid liabilities represents attractive funding due to longer terms than other financing options (securities lending, repo market, etc.)

The continuing growth potential has motivated the best advisors for various alternative strategies to source more opportunities, deepen insurance domain/regulatory knowledge, and customize strategies for inclusion in these complex portfolios.[5] The result has been a financial system restructuring that continues to scale despite the ongoing volatility in risk assets and move to higher yields and wider credit spreads that form a favorable outlook for more traditional investment classes. Many companies continue to believe the illiquidity premia remains attractive.

But unlike the ho-hum cadence of cyclical risk-taking in a cyclical industry, restructuring often requires multiple institutional changes, some of which become obvious after they arrive as big problems. The simple part is finding an alternative manager who has produced high returns in the past. But selecting a portfolio manager, in these particular sleeves, who meets this institutional segment's standards, is one of the few challenges that approach the difficulty of successfully managing these assets directly. Fortunately, as outsourcing by insurers and the universe of emerging managers have grown, an industrial strength due diligence process has been implemented by many companies. *The AAO model further crystallizes existing industry "outsourcing" policies and adds to them.*

GOING FORWARD -- DECISIONS THAT VALIDATE CONCERNS OR EVIDENCE BENEFITS OF THE AAO MODEL

Our proposition is comprised of AAO-related governance policies and business practices that put in place specific controls and seek strong results, respectively, on an enterprise basis.

Include Independent Directors Having Subject Matter Expertise

To avoid an actual or perceived conflict of interest, the AAO model necessitates (1) specific governance policies, (2) investment expertise in fiduciary roles external to the advisor, and (3) modification of the typical commercial relationship in fee structures and other terms to align interests more closely. By "alignment of interests," we mean a business model with long-term viability derived from equitably balancing the collective benefits and risks among all entities and their stakeholders while retaining performance compensation in key functional areas including underwriting and investments.

5 Recent estimates for U.S. insurance company assets under management are approximately $8 trillion.

Table stakes include an unambiguous *Conflict of Interest Statement.* The content should reflect the Governance Committee's effort to answer the question…*How can we prevent strategic relationships between affiliated entities from starting or going wrong for any one entity?* Potential answers, addressed in more detail below, will protect the insurer's policyholders, lenders and those with an equity interest other than the advisor while also recognizing the performance and contributions of the AAO.

The board should include independent directors with expertise in alternatives and insurance capital management. The absence of the specific experience needed to ask the right governance questions is the wrong means for respecting the important separation of fiduciary duties between the board and management.

> *Advisory Committees can also be helpful in a supplemental capacity. Membership would reflect areas where the Committee's sponsor wants information, including fresh ideas on a core operating strength or an in-depth review of other topics. Consultants, members of academia, former/unaffiliated regulators, and executives from trade organizations would provide a pool of qualified and appropriate candidates.*

Align Parties Through Fee Structure

One area where alignment strategy has significant potential is the fee structure. For example, lowering the advisor's standard (and relatively high) management fee should transfer, rather than diminish, compensation to their ownership interest, which may be shared with external shareholders and enterprise-wide employee equity compensation programs. When looking through the lens of AAO, other fee variables (hurdle rates, preferred returns, carried interest, and tax treatment) represent opportunities for alignment. Various constraints result in insurance portfolios leaning toward buy-and-hold vs. more active management. Fees should reflect any restrictions that reduce asset turnover relative to less-constrained investors.

Alignment of these economics, subject to minimum solvency metrics for the insurer in all cases, should lead to consequential enterprise-wide benefits *beyond* operating efficiencies. These include more objective and analytically based strategic/tactical allocation or alpha/beta portfolio decisions. Fee structures evidence the value of affiliation through a visible alignment of economic interests that recognizes all stakeholders.

Conduct Performance and Cost Analyses Annually

Investment consultants, or a direct report to the insurance company's Chief Investment Officer (CIO), should conduct an independent performance assessment of the AAO's portfolio management role in support of board governance. The consultant should make recommendations on benchmark selection/customization and the manager's peer group members, which is inherently more challenging with alternative strategies. The good news is that better data, information, and performance attribution software enables analysis that moves beyond absolute returns to risk factors and investment processes that reflect on the sustainability of returns. NDAs should be used to protect the advisor's proprietary systems.

Annually, the company or consultant should also conduct strategy-specific fee/expense comparisons versus the benchmark and peers. These assessments will need to adjust for the unique intra-enterprise business arrangements in the AAO affiliate structure, such as longer-term contracts and greater customization (described below). Replication strategies and exchange traded fund options should be in the scope of these reviews. The goal is to provide the board with an independent opinion in the context of external options. The consultant should also conduct these reviews periodically on asset classes and allocation decisions that remain the responsibility of insurance company employees.

Retain a Qualified and Authorized Chief Investment Officer

With limited exceptions, insurers should have, as an employee or contractor (otherwise unaffiliated), a qualified and fully authorized Chief Investment Officer dedicated to the company. Increasingly popular Outsourced CIO models can make sense in some respects, but generally only in the case of small and mid-sized insurers that lack internal investment resources, the governance structure to properly implement investment decisions, and the scale to generate operational and cost efficiencies on their own. We see an independent-minded executive in this position as necessary for all entities with meaningful allocations to affiliate advisors and for other reasons. The levered impact on financial results, including integrative risk management, more than offset any incremental cost of this functional management expertise. Even as the industry adapts, some best practices persist. This is one of them.

> *Potential Exception: Small and mid-sized companies and captives may be well suited to evaluate the tradeoffs of a complete outsourcing of the investment function.*

Design More Customized Product Features

Like companies with an affiliated investment entity (or internal investment staff) fully integrated with the core business, AAOs should realize benefits that are possible but more difficult with independent third-party managers. Given the initial distance between distinctive institutional requirements and alternative investment properties, these potential benefits are magnified here. As regulated balance sheets for operating companies, insurance portfolios are an engineering challenge that may not square with the standardized conventional terms offered by third-party managers to other investors.

For example, having little or no input regarding reinvestment or distribution of hedge fund profit puts the manager's preferences ahead of the insurer's changing business needs. Similarly, limited partner contractual obligations such as ongoing capital calls, commonplace in less constrained separate pools, will potentially increase the risk for an insurer where other variables, like capital and liquidity, are part of in-the-moment strategic and tactical decisions. Selling illiquid positions because they lack basic balance sheet customization for many scenarios is sometimes an option, subject to exit gates, but potentially a poor one depending on the market conditions. Bilateral discussions need to replace one-sided terms. Implementing these changes and others is facilitated within a fully integrated enterprise and, when pursued aggressively, further demonstrates the value of affiliation and alignment.

Within A Closed AAO Architecture, Formalize Alignment Contractually

Achieving advanced customization is easier said than done. Introducing separately managed account features that depart from a less constrained alternative strategy, but retain alpha and target factor exposures, is heavy lifting for any advisor. With this in mind, how will the goal of "equitably balancing the collective benefits and risks" occur from the advisor's perspective, especially when the customization borders on investment product reinvention? Achieving this balance is a question where creative engineering, a financial services trademark, can provide answers that signify shared interests over longer horizons. For example, the board's Investment Committee and CIO can designate the advisor-owner as their alternatives core manager, thus agreeing to a conservatively set minimum allocation for ten years and, in return, the advisor provides a minimum return guarantee (with performance-based upside), such as a fixed concession to the benchmark, or Treasury Bills +, etc. All such arrangements will have costs and financial statement implications that need to be vetted and weighed against the organizational benefits, which are considerable.

Leverage Advisor's and CIO's Respective Domain Expertise in Portfolio Construction

The scope and depth of expertise, and continuity of collaboration available through affiliation, represent a critical portfolio construction advantage in the AAO model. Investing by all investors in alternatives requires familiarity with well-proven due diligence and transaction mechanics dissimilar to traditional asset classes. Moving from there to asset allocation is where variation in investor needs takes place. Within the insurance industry, there are vast differences in the portfolio design process based on lines of business, jurisdiction, the form of ownership, and financial condition.

While all insurers need a deep understanding of their alternative investments, more levered writers of investment-oriented insurance products have the most at stake in terms of harmony within and across assets and liabilities. Some advisors' origination capabilities are more suitable to a specific balance sheet than a fund construct. However, increasing private debt and equity allocations requires modeling for the associated risks, including interest rate exposure, spread duration and illiquidity. One type of asset-liability risk centers on the rebalancing needed if long-dated liabilities paired to equity partnerships become unsynced with vintage year distributions/exits. A potentially significant business benefit to this design work, and the live track record that results, is increased advisory-market penetration and fees for the AAO as a third-party manager for external insurers.

At both the strategy and overall portfolio levels, a team of domain experts must avoid modifications that remove investment skills' impact and constrict sourcing or entry price advantages while retaining high fees as if complete discretion remained. In some cases, complementary steps (bank lines, hedges) are worth the cost of leaving the strategy in its original form. In others, the offset is not worth the price of admission or even possible. We refer to this process as *Active Customization*.[6]

Modeling and ongoing dialogue, both formal and informal, by this AAO team of aligned and integrated experts creates a natural persistence to find the best solutions to all these challenges. Both groups bring significant capabilities, such as balance sheet risk control and compliance from the insurer, and risk metrics most relevant to the alternative strategy (maximum downside, leverage, etc.) from the advisor. Data scientists should also have a prominent role bridging the specialists. Model validation protocols should be in high use.

Support Regulatory Initiatives and Academic Research

Research teams are developing analytical models for the wider industry and the complete set of alternatives in which insurance companies invest. Multiple overlapping initiatives are underway at the NAIC that will impact the alternatives market, such as Actuarial Guideline 53 that requires heightened analysis of complex assets and additional reporting of management fees and affiliate and related party investments, a principles-based approach to classification of assets that receive favorable capital treatment, heightened disclosure for investment funds, and differentiation of structured securities.[7] In the latter category, there is an intense focus on the treatment of CLOs, certain structures of which are exposed to risk factors, such as equity, different than those of other credit assets, and between different structures/collateral. We advocate adding reviews of alternative strategies seeing growth in the insurance segment.

The alternatives trend also presents an exciting research opportunity for regulators, capital market participants, and academia. Nothing less. Potential macro studies include comparisons of the active/passive dynamic in public vs. private markets for all levels of the capital stack. We also need better stress tests that capture how companies reducing their excess liquidity also magnify a larger capital downside in their increasingly reduced go-to government holdings, as a liquidity backstop in a systemic liquidity crisis. *Does this portfolio shift represent the next crowded trade in the making?* Regulators will be interested if AAOs are adding alternatives in relatively greater amounts than peers and, if so, the research basis for doing so. These questions create a new frontier for research in insurance asset management.

NEXT STEP – EXECUTION

Skillful navigation of the issues we've outlined will significantly impact the results for all constituents. We have not conducted a survey but have observed companies taking some of the steps we've presented, and they deserve recognition. While not all organizations need to take the complete set of actions, excluding any of these basic components should have strong justification. Ongoing public comments are helpful. Progress will accelerate through active collaboration among all parties who (1) represent the full scope of relevant expertise, and (2) bring critical thinking, great questions, objectivity, and a sense of urgency. We recognize that others will see things differently, which is the necessary ingredient for quality control, and we look forward to the ongoing dialogue. The industry has a lot at stake.

We want to thank senior industry executives in various roles and from different organizations who contributed to this article.

6 *Enterprise Driven Investing for Insurers V2.0 - Active Customization*, Insurance AUM Journal, Oct. 2021; Poutsiaka, Crow, diBartolomeo, Pohlman.

7 Bridgeway Analytics Asset Regulatory Treatment *Newsreel*.

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About Bill Poutsiaka

Bill Poutsiaka is a senior financial services executive with considerable experience and accomplishments, including successful strategic and operational transformation, as CEO, Chief Investment Officer and board member for global insurance and asset management businesses. He is currently consulting, doing board work, research on application of emerging data science methods, advising/coaching fintech organizations and startups, publishing, and speaking at conferences and universities. Bill has served as an active director on the boards of public, mutual, private and non-profit organizations. These organizations have included global, domestic, large, small, multiline and highly specialized insurance and investment entities. His executive roles include Chief Investment Officer & SVP of AIG Property Casualty following the financial crisis; CEO of quantitative firm PanAgora Asset Management, and CEO Arkwright Mutual Insurance Co which he merged to form FM Global. Bill began his career in the investment department of the Liberty Mutual Insurance Co. He received a B.A. from Muhlenberg College and an M.B.A. from Boston College's Carroll School of Management where he was later the first recipient, and commencement speaker, of the Distinguished Achievement Award for managerial excellence and community service.

About Deborah Gero

Deborah Gero is a seasoned professional in investment management, risk management and insurance company management. Ms. Gero serves as an independent director on the boards of Oaktree Capital Specialty Lending Corp., Newport Re, LTD, is a member of the Subscribers Advisory Board for United Educators, and a trustee for the Oaktree Strategic Credit Fund. She also serves as a director of the not-for-profit, Friends of the Brentwood Art Center and on the Investment Committee for Los Angeles United Way. Other professional experience includes serving as Senior Managing Director and Deputy Chief Investment Officer of AIG Asset Management where she was responsible for oversight of investment strategy for $300 billion of life and property casualty insurance portfolios worldwide. Previous positions at AIG included Chief Risk Officer for the Life and Retirement division. Ms. Gero' s other experience in the industry includes those of a portfolio manager for a $3 billion collateralized debt portfolio, head of asset/liability modeling and management for insurance companies, director on life insurance and asset management company boards, and a key member of insurance company merger and acquisition analysis and deal teams at SunAmerica, Inc. and Conseco, Inc. Ms. Gero has a Bachelor of Arts degree in mathematics from University of Notre Dame. She is a Chartered Financial Analyst and a Fellow of the Society of Actuaries and Member of the American Academy of Actuaries.

About Amnon Levy

Inspired by everchanging financial markets, Amnon Levy founded Bridgeway Analytics to support the investment and regulatory community navigate ever-increasingly complex capital markets. Bridgeway Analytics offers solutions that improve efficiency and income generation by bridging practitioner needs for accelerated tactical and strategic decisioning with practical performance metrics. Prior to forming Bridgeway Analytics, Amnon Levy was a Managing Director at Moody's Analytics (previously KMV), where he led development of award-winning quantitative solutions actively used by the investment, lending, risk, ALM, treasury, and financial reporting functions at 200+ banks, insurance companies, pension funds, and asset managers. Amnon has led numerous initiatives that improve on industry best practices and regulation, including the 2021 redesigned NAIC regulatory guidelines for life insurance ~$3 trillion credit holdings. He holds a B.A. in Economics from the University of California at Berkeley and a Ph.D. in Finance from the Kellogg Graduate School of Management, Northwestern University. Prior to joining Moody's Analytics (originally KMV), Amnon was a visiting assistant professor at the Stern School of Business, New York University, and the Haas School of Business, University of California at Berkeley, and had worked at the Board of Governors of the Federal Reserve System. Amnon's research has been widely published in academic and practitioner journals. His co-edited book "Credit Risk Measurement and Management: Disruption and Evolution," remains on the Risk Books best seller list.