AIC | Aon White Paper

Review of Alternative Asset Managers' Involvement with Life & Annuity Insurers

2022

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I. Executive Summary

Aon Inpoint conducted an objective study on behalf of the American Investment Council (AIC) analyzing Alternative Asset Managers' (AAMs) investment into the Life & Annuity industry and how insurers' portfolios have evolved over time as a result of AAMs' investment expertise[1]

Alternative Asset Manager Investment into the Life & Annuity Industry

Life & Annuity (L&A) insurers offer insurance policies to consumers to fulfill multiple needs such as providing death benefits to beneficiaries as well as supplemental retirement income in the form of annuities. The long-term nature of these policies, including some lasting more than 30 years, requires insurers to invest in long-duration assets to match the liabilities that come with meeting future obligations to policyholders, while seeking suitable yields to cover short-term obligations and earn a return. Declining yields in recent years, driven by a historically low interest rate environment, have put pressure on the industry as higher-yielding investments mature and are replaced with lower-yields. This adversely impacts older policies that often have higher minimum guaranteed rates of return surpassing the yield of these newer investments. As a result, insurers have a historically low net spread, which reduces net income and potentially creates liquidity challenges.

Alternative Asset Managers have played a role in the L&A industry for decades by providing investment products, managing portfolio assets, and, more recently, through direct equity investments into L&A insurers. This type of investment typically takes one of two forms. The first being a traditional strategy of acquiring companies, improving operations, growing revenue, and then exiting profitably to the benefit of the AAM and its customers (limited partners) as well as the L&A insurer. More recently however, AAMs have increased their focus on longer term partnerships and permanent strategic relationships, including many with L&A companies or assets that benefit from the capabilities of their investment teams that specialize in non-traditional and more complex assets (e.g., private credit). Given the challenge of declining yields in recent years, insurers have increasingly gravitated toward AAMs' investment capabilities via reinsurance agreements, asset sales, selling their entire operation, or establishing a strategic investment management agreement (IMA). AAMs have become an important source of funding (and in some cases the only source) for many of these strategic transactions in the L&A sector, investing $37B since 2010, resulting in an 11% share of total L&A cash and invested assets in 2021.[2] Public markets have only invested a fraction of that amount over the same period, given the capital intensity and modest growth outlook for the sector, with many releasing capital in the form of dividends and share buybacks.

A more well capitalized L&A industry and greater investment specialization should allow insurers and their policyholders to leverage AAMs' ability to reduce solvency risk via enhanced yields: AAM-owned insurers generated higher earned income as a percent of cash and invested assets since 2017 compared to non-AAM owned insurers, while investment expenses have remained

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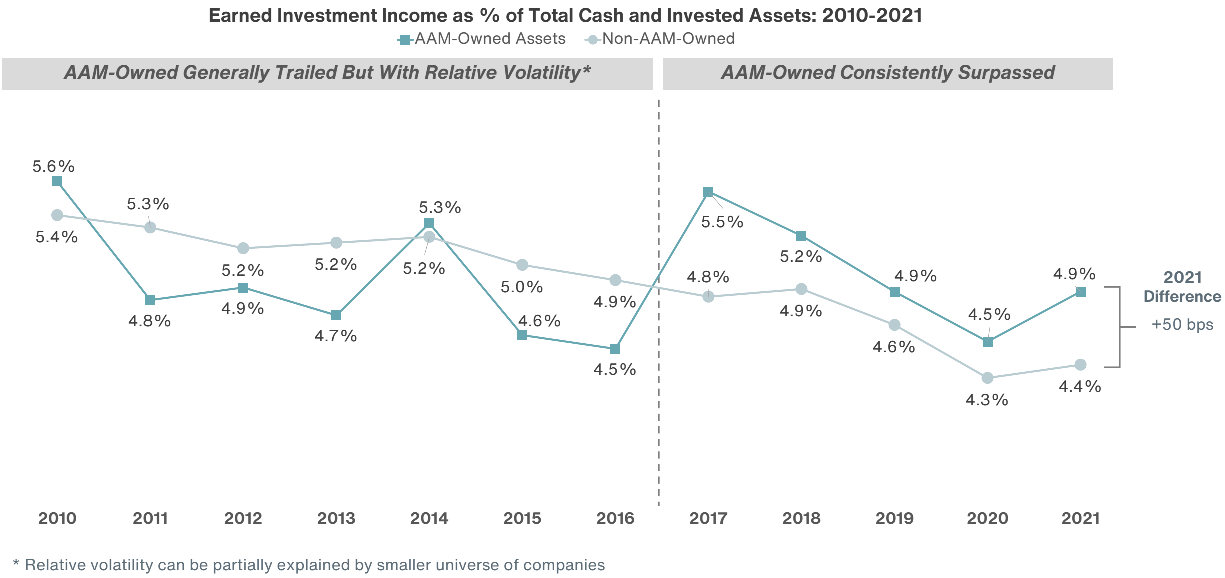
[1] Aon Inpoint has relied primarily on publicly available statutory financial data for the supporting quantitative analysis (please see Section VI. Methodology for additional detail); factors not incorporated into statutory investment-related financial disclosures are outside the scope of this analysis

[2] According to Aon Inpoint analysis, see Methodology section for further detail

relatively flat[3]. There is additional value for insurers and their policyholders that can free up cash from exiting these capital-intensive blocks of business for higher returns on investment (ROI).

Exhibit 1



Source: Aon Inpoint Analysis, SNL Statutory Data

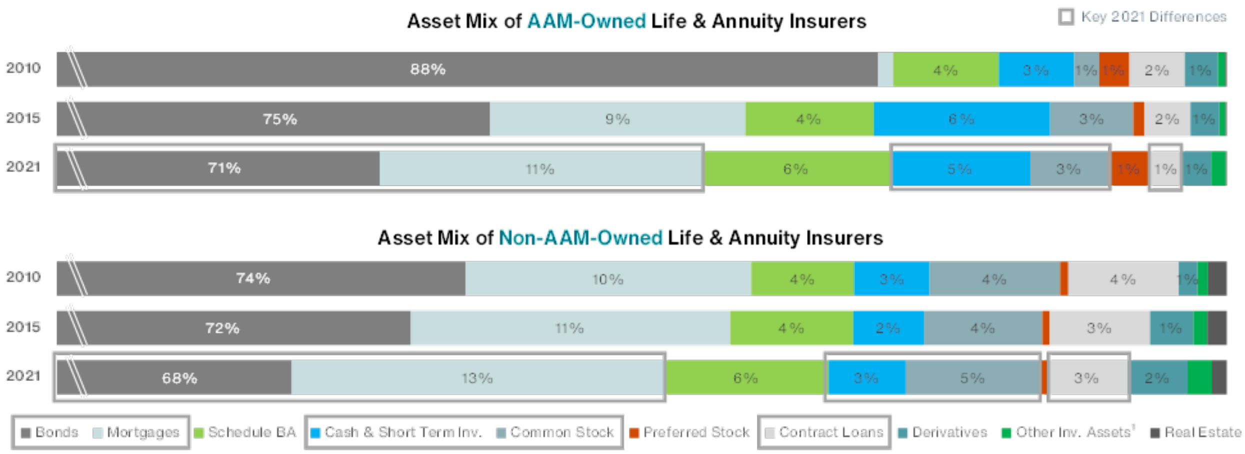
Looking forward, for these reasons, the partnership between AAMs and L&A insurers is expected to continue despite increasing interest rates taking some pressure off the search for yield and near-term economic uncertainty potentially reducing M&A volumes. Access to specialized investment expertise and origination capabilities is expected to be a continued focus for L&A insurers as they seek to better serve policyholders through stronger returns.

Insurers' Investment Portfolios

The investment portfolios of AAM-owned and non-AAM-owned insurers are relatively similar across major asset classes, including alternative assets in Schedule BA (e.g., Hedge funds, Private Equity, etc.). The most significant investment allocation difference is that AAM-owned insurers have a greater allocation to private bonds, specifically asset-backed securities (ABS). Since 2010, AAM-owned insurers have transitioned a significant portion of private bond investment away from corporate bonds and into ABS, which can achieve higher yields due to increased complexity and illiquidity premiums (rather than incremental credit risk), which can be considered well-aligned with L&A companies' given the long-duration of their liabilities and their focus on appropriate asset-liability matching (ALM). This transition to a higher concentration of ABS investment coincides with consistent outperformance (+20 bps) on overall bond earned income since 2015, relative to non-AAM-owned insurers.

[3] SNL Statutory Data as of June 2022

Exhibit 2



Source: Aon Inpoint Analysis, SNL Statutory Data

1. *Other Invested Assets includes Investments Not Classified Elsewhere, Other Receivables, and Securities Lending (Reinvested Collateral)*

Losses stemming from the 2008 financial crisis, which were primarily driven by defaults in mortgage-backed securities (MBS), have led to some concerns around the associated risks of other structured securities such as ABS products. Multiple studies (cited throughout), however, demonstrate ABS' historically low default rates, which are comparable to, or lower than, similarly rated corporate bonds. Additionally, ABS are generally structured with several investor protections, monitored and stress-tested by insurance regulators, and governed by insurers' internal risk management policies. Both AAM-owned and non-AAM-owned insurers maintain over 90% of their bond portfolios in investment grade tranches rated by independent rating agencies and the National Association of Insurance Commissioners (NAIC). Given these factors, it appears that AAM-owned insurer portfolios maintain a similar credit risk level to non-AAM-owned insurers despite the varying concentration of ABS and corporate bonds. Additionally, the long-term nature of L&A insurers' liabilities makes these investments well-aligned to navigate the relative illiquidity of private structured credit.

It is anticipated that investment in ABS, and private credit more broadly, will continue for the entire L&A industry considering the attractive risk profile and yields. Modest changes to portfolios are anticipated with the NAIC recently introducing more granular risk-based capital charges for various bond ratings and lowering capital charges for Schedule A and Schedule BA [4]real estate. Portfolios

[4] Schedule A (real estate assets) and Schedule BA (long-term assets) are alternative asset categorizations that are required by insurers to be reflected on particular regulatory and / or statutory financial disclosures and filings

may further evolve as the NAIC considers modifications to risk-based capital charges for different tranches of collateralized loan obligations (CLOs). Despite potential regulatory changes, it is expected that both AAM-owned and non-AAM-owned insurers will continue to utilize private credit as a key part of their investment strategies.

II. Introduction

The AIC seeks to provide insights to policymakers and other stakeholders on AAMs' involvement with the L&A insurance sector. AAMs are financial services firms that have specialized capabilities in alternative assets such as real estate and private credit/equity, in addition to traditional assets such as publicly traded stocks and bonds. To provide an objective study, AIC engaged Aon Inpoint to examine the history and outlook of AAM investment into the L&A industry and how insurers' holdings of alternative assets have evolved. Utilizing proprietary databases, research affiliates, and third-party data sources, Aon Inpoint quantified and assessed the historical development of investments with the L&A industry and analyzed the historical evolution of insurers' investment portfolios, segmented by those that are AAM-owned as compared to non-AAM-owned.

Quantitative insights were supplemented with interviews with insurance industry experts from multiple AAMs and other subject matter experts to understand strategic considerations driving such investments and portfolio allocations, as well as to develop a prospective view of trends. Furthermore, Aon Inpoint examined Risk Based Capital (RBC) requirement changes that the NAIC recently enacted and is currently exploring to assess how these may impact future investments.

III. AAM Investment into the Life & Annuity Industry

The relationship between L&A insurers and AAMs has spanned several decades, with AAMs providing investment products and asset management services to insurers, as well as L&A insurers taking ownership stakes in asset managers or investing as limited partners (LPs). In recent years, this partnership has evolved. As downward pressure on interest rates created a challenging environment for L&A insurers and their policyholders, insurers accepted direct equity investment from AAMs, seeking to benefit from the additional capital and their specialized investment expertise to generate higher yields, and ultimately, better outcomes for policyholders. Moreover, the long-term liabilities of the L&A industry align with the long-term investment strategies of AAMs, resulting in long-term partnerships driving investment into the space.

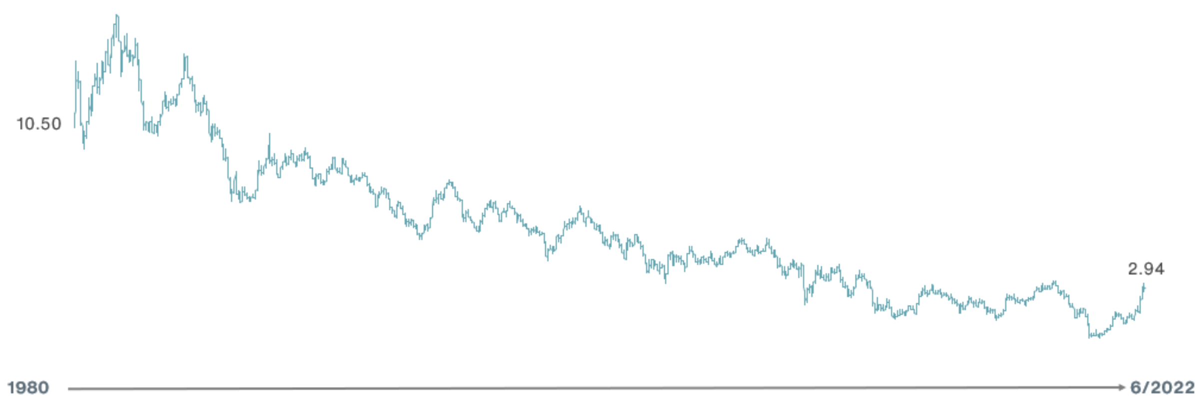
A. L&A Insurers: Seeking Higher Yield

Traditionally, life insurers primarily offered term life insurance that provided a death benefit for a stated time-period to act as a safety net if the sole breadwinner of the family were to pass unexpectedly. Post WWII, consumers began prioritizing longer-term savings beyond their working years. Whole life insurance became increasingly preferred as these policies provided a guaranteed death benefit and accumulated cash values that could be redeemed prior to passing. Increasing longevity, higher medical costs, and the need to generate sufficient income in retirement created a surge in demand for annuities, resulting in a large shift in insurers' overall product mix. In 2021, annuities accounted for nearly two-thirds ($286B) of the total L&A direct premium written[5]. Annuities may be structured as either fixed or variable. Fixed annuities provide guaranteed returns and are usually backed by a high concentration of corporate or government bonds that are held in an insurer's general account. Variable annuities have a rate of return that is determined by the performance of the investments in their portfolio and are held in a separate account. For both annuities and life insurance, consumers generally pay monthly premiums to insurers who invest those funds (assets) and commit to paying out a fixed income stream or single payout in the future (liabilities).

Given the long-term structure of L&A policies, which can be over 30 years in duration, insurers must match the duration of their invested assets with their liabilities to achieve sufficient yield to cover policyholder obligations, while adhering to regulatory capital requirements. Insurers cannot always find relatively low-risk, high-yield, and long-duration assets to match annuities that guarantee a minimum annual return, meaning that some mismatch of assets is likely to occur. In certain cases, insurers may run modest duration mismatches to enhance investment spreads. Over the last 10 years, as a portion of higher-yielding assets (mostly bonds) from the higher interest rate period matured, they were replaced with lower-yielding assets given the historically low interest rate environment (Exhibit 3), putting significant pressure on the industry. Older fixed income insurance products, with relatively higher minimum guaranteed rates of return to policyholders (e.g., 6% or more), surpass more recent investment portfolio yields, leading to spread compression, reduced net income, and potential liquidity challenges for insurers. However, this may be partially offset as policyholders are more likely to keep their money in annuities due to the limited availability of higher-yielding alternatives. Since 2006, yields have declined more significantly than guaranteed rates, resulting in a historically low net spread in 2020 (Exhibit 4).

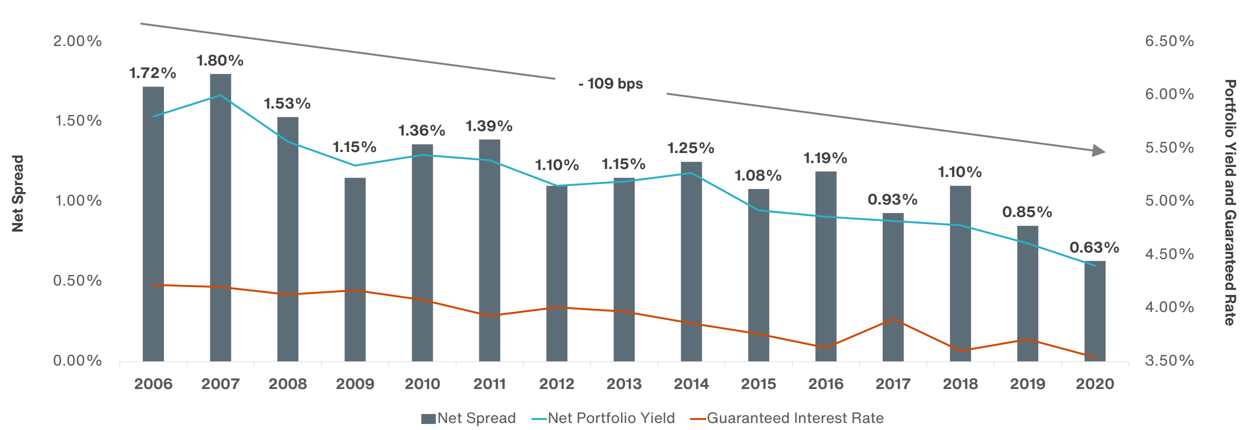
[5] According to S&P Global Market Intelligence

Exhibit 3



Source: St. Louis Federal Reserve Economic Data (FRED)

Exhibit 4



Source: NAIC, "Low Interest Rates"

> *"Some **variable annuity insurers were severely impacted by the 2008 financial crisis**, as they were offering **guaranteed returns of up to 8%** to attract policyholders prior to the crisis"* – AAM Practitioner

Over the years, insurers have responded to these challenging market conditions in a variety of ways:

- Raising premiums and/or further lowering guaranteed rates, in each case to the detriment of policyholders
- Taking on additional investment risk in search of yield
- Divesting parts of the business that are less profitable and/or more capital intensive
- Adjusting asset and liability duration mismatches

Some larger insurers have either developed specialized in-house investment capabilities to target higher yields from more complex and non-traditional asset classes or have obtained these capabilities inorganically through acquisition. The resource commitment needed to build or buy sophisticated investment management capabilities, including specialized expertise, trading infrastructure, and institutional knowledge, may be cost prohibitive for many small and medium-sized insurers.

> *"With growing assets on hand and **volatile interest rates and inflation**, the potential for **asset-liability mismatches is at an all-time high**. This combination of volatile markets and a challenging economic environment put an even greater premium on the **need for sophisticated asset management**."*
>
> – AAM Practitioner

Historically, many insurers have established IMAs with third-party AAMs providing insurers with access to these specialized investment capabilities in their search for higher yields. In 2021, 30% of L&A insurers outsourced over 50% of their assets to an unaffiliated[6] investment manager. This approach makes the industry more competitive across insurers of various sizes, with the ultimate beneficiary being the policyholder. IMAs have several guardrails in place to protect the insurer and the policyholders, such as standard of care terms ensuring AAMs operate in a fiduciary capacity regarding their investor's assets at all times, requirements for AAMs to provide details on their liability insurance coverages and certificates of insurance to their investors to ensure adequate levels of protection are in-force, and proxy voting terms that allow L&A insurers to direct the AAM with respect to the voting of proxies relating to securities held by the master trustee. Additionally, within IMAs, insurers typically provide their approval on AAMs' recommended asset allocations for their portfolios before any shifts occur. Other core elements of IMAs that provide transparency to L&A insurers are regular investment activity, performance, and benchmarking review meetings, key person provisions, and asset valuation methodologies. These strategic IMAs are negotiated at arms-length and are highly customizable based on an insurer's asset allocation preferences, capital budget, ALM program, product suite and other aspects of their business and operations.

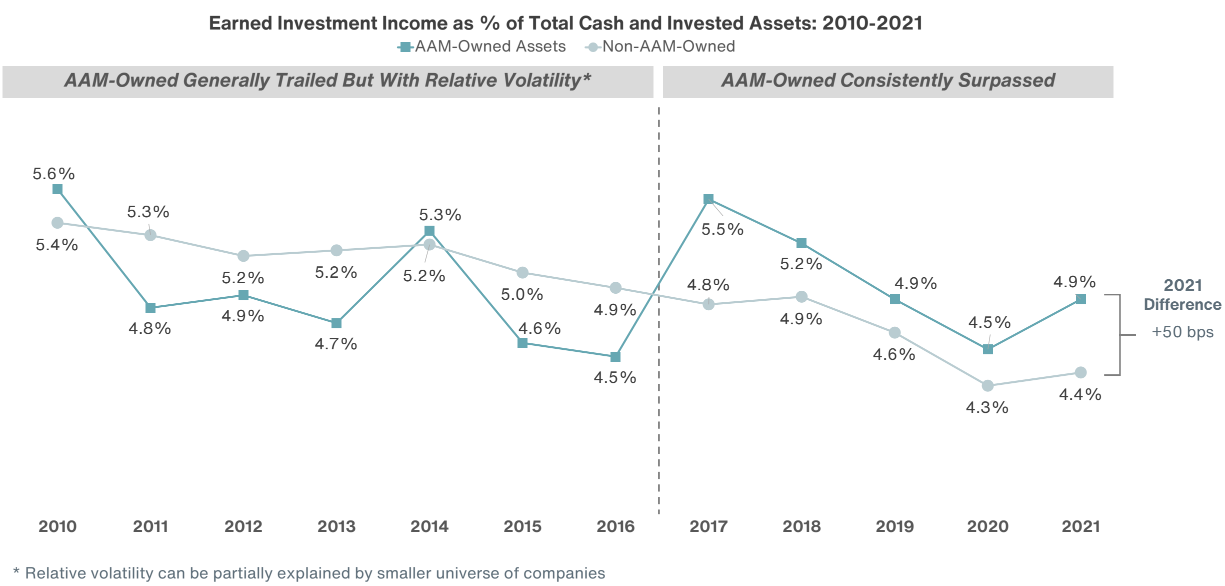
[6] Unaffiliated investment managers are those who do not own an equity stake in the company whose assets they are managing

> *"Small insurers **may not have access to the best investment opportunities**. If an insurer has $10B of AUM, maybe 10% is in private credit. **They won't get a lot of attention from the top asset managers**. But **once acquired, then they have access to a much wider range of investments**."* – AAM Practitioner

Another approach for L&A insurers to mitigate spread compression is to exit less profitable and capital-intensive blocks of business. This provides several additional benefits, such as improving valuations as less asset and capital-intensive insurers have generally been valued higher. Insurers also free up capital to invest in higher return on investment (ROI) initiatives and optimize their business mix. As a result, L&A insurers are increasingly divesting parts of their businesses, selling their entire operations, and/or reinsuring large blocks of legacy business.

Many of the recent, larger transactions in the L&A industry have occurred with AAMs. Since 2017, AAM-owned insurers modestly outperformed non-AAM-owned insurers consistently with a 2021 difference of +50 bps (Exhibit 5). In some cases, AAMs provide additional value by upgrading legacy technology and driving process improvements to reduce ongoing operating costs.

Exhibit 5



Source: Aon Inpoint Analysis, SNL Statutory Data

> *"Private equity has a history of **improving operational performance** while **increasing returns**. Historically many **blocks of business were underinvested**, leaving money on the table and putting the policyholders at risk."* – AAM Practitioner

B. AAMs: Evolving Strategies

The strategy of AAMs as it relates to the L&A insurance market can be segmented into two primary approaches, both of which are common. The first is a more traditional "buyout" approach where AAMs raise funds with finite time horizons, acquire companies, enhance the value of those companies by increasing revenue and creating operational efficiencies, and then exit profitably. This approach can be challenging, given the limited ability to deploy leverage in such buyouts. The second strategy focuses on sourcing permanent capital through strategic partnerships established on arms-length terms, which became more common in the L&A industry following the 2008 financial crisis and has become increasingly more prevalent in recent years[7]. For L&A insurers, this strategy provides stability in the form of a long-term partnership, where goals can be aligned to serve the best interest of both the company and the policyholders over time.

To support this second strategy, many AAMs have recently scaled their private credit management capabilities. Private credit as an asset class refers to loans, bonds, and other credit instruments that are issued in private offerings. While the growth in private credit is a decades-long trend, AAM participation accelerated since 2005. Private credit funds raised $191B in 2021 and have an annualized growth rate of 11% since 2012[8]. Among the four largest publicly traded US AAMs, assets under management (AUM) of their credit funds rose 17% per year between 2012 and 2018, compared with 12% for their equity funds. In 2018, credit investment represented a greater share of AUM than equity[9]. AAM expansion of private credit capabilities aligns with an L&A industry that is increasingly shifting assets to private fixed income in search of additional, risk-adjusted yield. Given their core competencies and experiences of dealing with the complexities of equity investing, AAMs are well-suited to apply those capabilities to evaluate and invest in private credit.

> *"It used to be just private equity funds focused on the Life industry, but now many **asset managers have more private credit than private equity** as private credit management has scaled dramatically. The credit side is a closer fit for these types of life insurer investments."* – AAM Practitioner

> *"We seek to **increase insurer's financial health and profitability** through **improving operational capabilities,** including policy administration, **robust risk-management, efficient capital management, and investment management** that delivers attractive risk-adjusted returns"* – AAM Practitioner

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[7] Warren Buffet is considered to have pioneered the permanent capital model in the P&C industry beginning with Berkshire Hathaway's acquisition of National Indemnity in 1967

[8] Pitchbook, "2021 Global Private Debt Report"

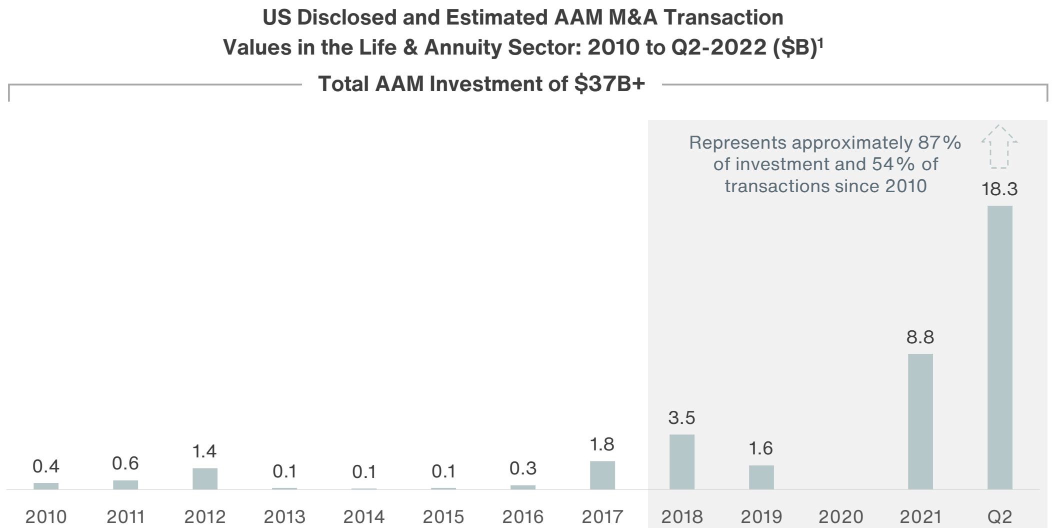
[9] Bank for International Settlements, "Private credit: recent developments and long-term trends"

C. Mutually Beneficial Partnerships

While providing long-term capital is a key value-driver of the relationship between L&A insurers and AAMs, the extent of their partnership and the role AAMs assume goes well beyond their initial and ongoing capital investment. AAMs serve as long-term strategic partners and advisors to their L&A insurers that enable them to leverage the scale and expertise of AAMs to enhance their own performance, strategies, and infrastructure. Through these partnerships insurers have the opportunity to bolster organic growth strategies in ways such as, expanding distribution networks or accelerating product development efforts. Additionally, L&A insurers can capitalize on their AAM-owner's resources to advance their technology stacks and digitize core elements of their operation in what has been historically an inefficient, analog L&A industry. The mutual partnership can bring together new, performance-centric perspectives, experiences, and skillsets at the management level that can support insurers' growth and efficiency objectives, all leading to better outcomes for policyholders.

As a result, the motivations and strategic goals of AAMs and L&A insurers have converged to create an attractive M&A environment, which is evidenced by the amount of investment into the sector. AAMs have become an important source of investment (and in some cases the only source) for the L&A sector. Between 2010 and 2022, there was an estimated $37B in M&A activity by AAMs in the US L&A industry (Exhibit 6). AAM interest has increased substantially in the last five years as transactions from 2018 to Q2-2022 represent approximately 87% of investment volume and 54% of deal count since 2010. The amount of equity raised in public markets over the same period represents a small fraction of private capital investment. Public markets generally view the industry as less attractive given capital intensity and modest growth and return outlook.

Exhibit 6



	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	Q2 2022
AAM Transactions	2	4	2	2	3	3	2	1	7	7	0	5	3
Total L&A Transactions[2]	28	27	30	25	17	28	27	31	26	22	13	24	N/A

Source: Aon Inpoint Analysis, SNL M&A Transaction Data, Deloitte 2022 Insurance M&A Outlook

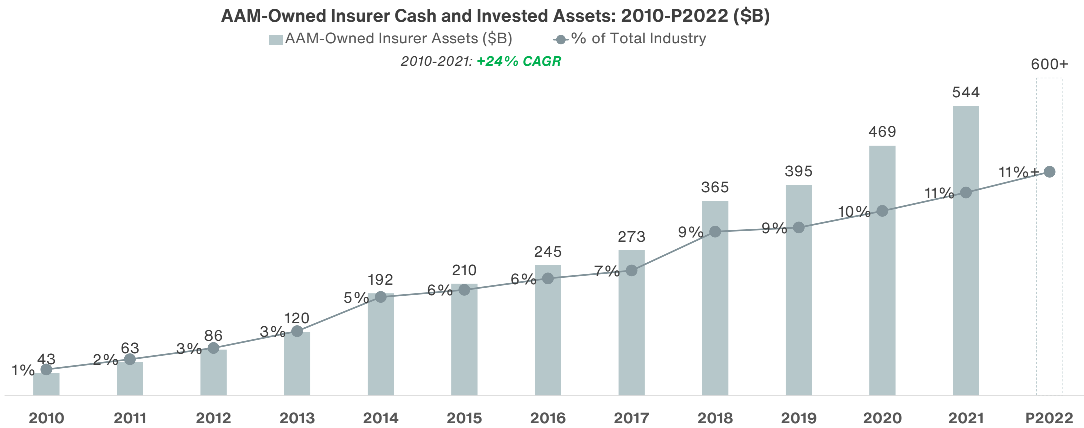
1. *See Methodology section for more detail*
2. *Deloitte, "2022 Insurance M&A Outlook". Includes all US and Bermuda companies making acquisitions on a global basis and international buyers making acquisitions in US and Bermuda*

Some AAMs obtain a minority equity interest in a L&A insurer and enter into a strategic IMA, which creates strong alignment of interest between firms. In particular, this minority equity stake deepens the partnership between the AAM and L&A insurer as there is a vested ownership interest that brings cross-firm strategic planning and growth alignment, while enabling the insurer to retain its established governance structure.

As AAMs' focus on the L&A space continues to increase, total cash and invested assets of insurers under both controlling AAM-ownership and non-controlling interest, including those insurers with identifiable IMAs and some level of AAM equity ownership, has increased from 1% of the total L&A market in 2010 ($43B) to 11% in 2021 ($544B)[10]. There were 22 distinct AAM owners of 53 AAM-owned L&A insurance entities in 2021, which is anticipated to grow in 2022 given recently completed and announced deals (Exhibit 7).

[10] See methodology section for more detail

Exhibit 7

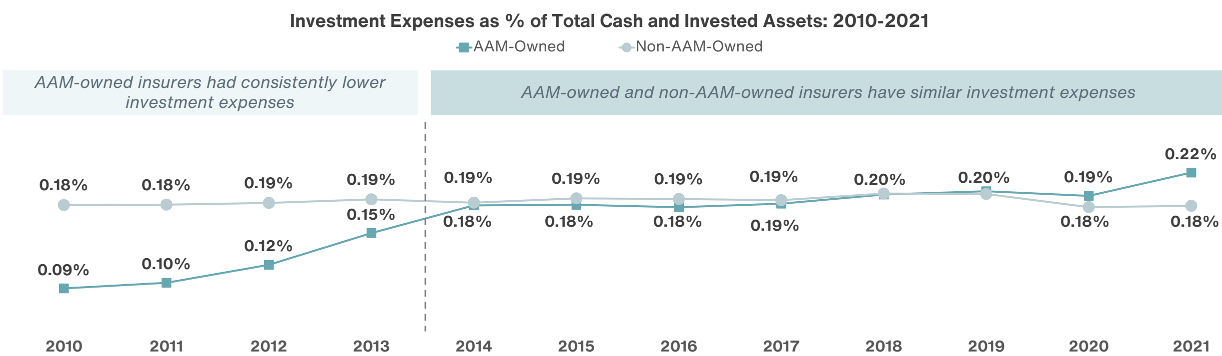


	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	P2022
# of Insurance Entities	13	17	20	24	30	35	40	41	50	45	52	53	55+
# of Distinct AAM Owners[1]	8	11	14	15	16	17	18	19	22	19	21	22	22+

Source: Aon Inpoint Analysis. SNL Statutory Data

While AAM ownership has increased, investment expenses of AAM-owned insurers have remained steady and comparable to non-AAM-owned insurers in recent years. Between 2014 and 2020, investment expenses were 0.18% to 0.20% of total cash and invested assets with a slight increase for AAM-owned insurers in 2021 (Exhibit 8).

Exhibit 8



Source: Aon Inpoint Analysis, SNL Statutory Data

D. Outlook for Continued Investment

It can be expected that M&A will continue in the L&A industry, although competition remains high as AAMs have recognized the opportunity to not only deploy long-term capital but also partner with L&A insurers to enhance their operation and performance through AAMs' scale, resources, and expertise. However, limited leverage and modest underlying profitability may provide a challenge to M&A transaction volume in the sector. AAMs that have an established infrastructure and demonstrated performance managing insurance assets are best positioned to establish strategic relationships with L&A insurers through M&A opportunities.

For L&A insurers, increasing bond yields in the near-term may reduce pressure to access more specialized investment expertise from AAMs as their financial position improves and the spread between investment returns and minimum guaranteed policyholder returns are expected to widen. However, insurers with a long-term view can be expected to consider expanding investment capabilities, including through relationships with AAMs, to better position themselves during future economic cycles in which traditional investment returns are again compressed. As such, the mutually beneficial relationship that exists between AAMs and L&A insurers should continue to drive more private capital into the sector while public markets remain a limited source of funding.

Furthermore, if liquidity and complexity margins increase, that is likely to make private credit even more attractive for L&A insurers. Despite the continued demand, M&A transaction volumes may slow due to economic uncertainty, but this is likely to be transitory.

> *"The market is **very competitive**, and it will be **hard for a new entrant without an established infrastructure to compete**. I don't see a lower volume of opportunities, but rather **more opportunities for existing players**"*
>
> – AAM Practitioner

IV. Insurers' Investment Portfolios

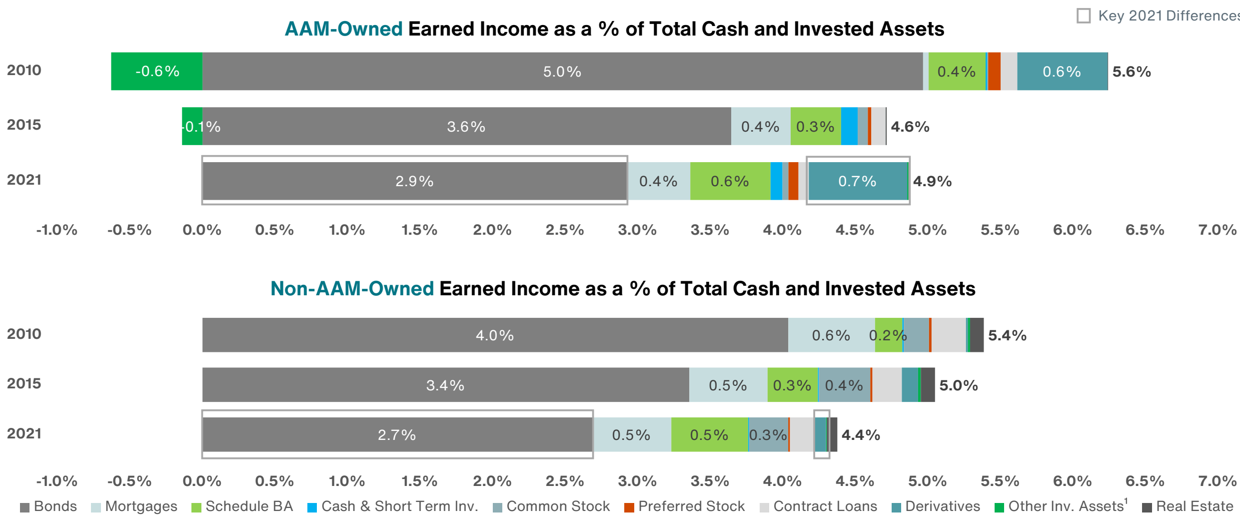
AAM-owned insurers are achieving modestly higher yields through higher allocations to private credit investment, specifically ABS, while maintaining credit ratings comparable to non-AAM-owned insurers.

A. Earned Income by Asset Class

Portfolio yields have decreased since 2010 across the L&A industry with AAM-owned insurers outperforming non-AAM-owned insurers in recent years. Segmenting by asset class shows that bonds represent more than half of the earned income as a percent of cash and invested assets of both insurer groups but have also steadily declined over time (Exhibit 9). Despite the decrease, AAM-owned insurers consistently outperformed non-AAM-owned insurers on their bond portfolio by at least 20 bps annually since 2015[11], indicating that the specialized investment expertise and capabilities of AAMs is contributing to incremental yield. As the search for incremental yield continues, insurers will likely continue to build out specializations focused on assets with higher expected returns, where additional expertise may be needed to effectively manage the associated complexities.

[11] In 2021, AAM-owned insurers outperformed non-AAM-owned insurers by 50 bps on earned income as a percent of total cash and invested assets

Exhibit 9



Source: Aon Inpoint Analysis of SNL Statutory Data

1. *Other Invested Assets include Investments Not Classified Elsewhere, Other Receivables, and Securities Lending (Reinvested Collateral)*

B. Overall Asset Mix

The differences in yields can be better understood by examining the asset allocation of AAM-owned and non-AAM-owned insurers. Overall, the asset mixes of both groups have become more similar over time with minor variances in bonds, mortgages, cash, common stock, and contract loans[12] (Exhibit 10). In 2021, bonds comprised the largest exposure in both AAM-owned and non-AAM-owned insurers, accounting for 71% and 68% of assets, respectively. Bond allocations have decreased since 2010 with the most significant decline coming from AAM-owned insurers. This shift by L&A insurers, regardless of ownership, from bonds into other asset classes is largely driven by the search for yield in response to a historically low interest rate environment

Mortgages represents the second largest asset class, which totals 11% of assets for AAM-owned and 13% for non-AAM-owned insurers in 2021. This is followed by "Schedule BA", which is composed of long-term alternative asset investments such as private equity, real estate, and hedge funds, and represents 6% of assets for both groups. The NAIC reports that while the "...industry's exposure to long-term investments reported on Schedule BA has increased significantly over the last decade, it should not represent a material risk in a stressed environment because of the relatively small concentration..."[13]. The next major asset class is cash and short-term investments, where AAM-owned insurers have generally maintained a higher concentration compared to non-AAM-owned insurers (5% vs. 3% in 2021). Additional cash is often held to offset the illiquidity risk associated with a relatively higher proportion of private fixed income investments and reflects prudent asset management.

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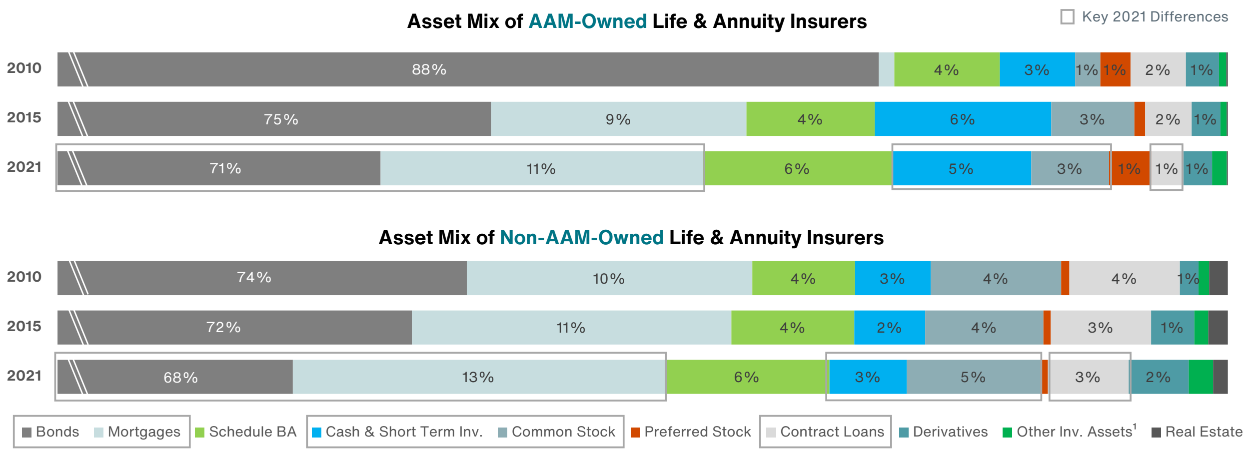
[12] A policy (or contract) loan shall be defined as a loan to a policyholder, under the provisions of an insurance contract that is secured by the cash surrender value or collateral assignment of the related policy or contract

[13] National Association of Insurance Commissioners (NAIC), "U.S. Insurance Industry's Exposure to Schedule BA Assets Continues to Rise in 2020"

Exhibit 10



Source: Aon Inpoint Analysis, SNL Statutory Data

2. Other Invested Assets includes Investments Not Classified Elsewhere, Other Receivables, and Securities Lending (Reinvested Collateral)

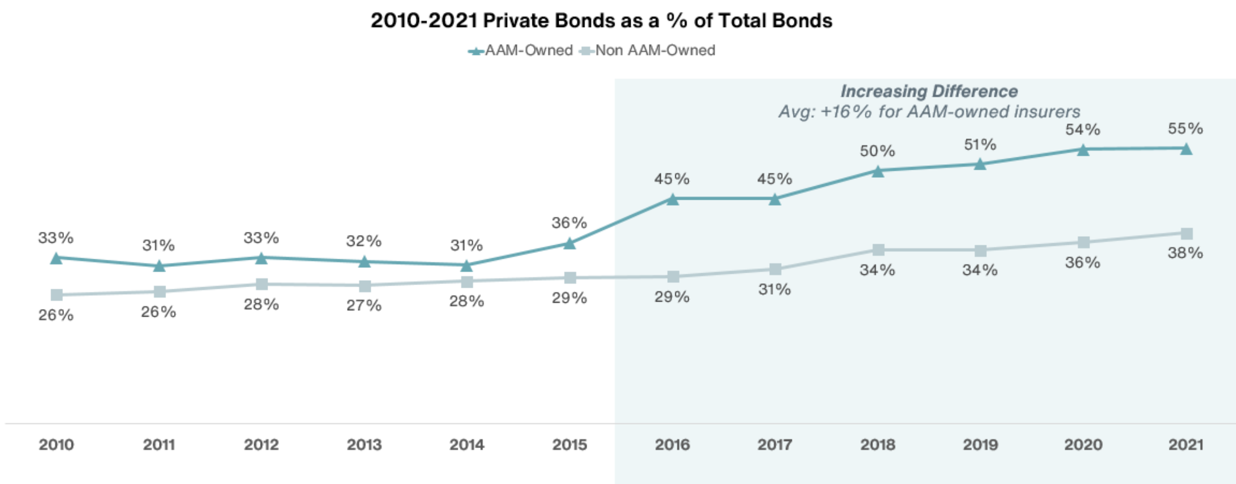
C. Public vs. Private Bonds

The public vs. private composition of bond portfolios is where the most significant difference exists between AAM-owned and non-AAM-owned insurers investment approach (Exhibit 11). In 2021, private bonds accounted for 55% of AAM-owned insurers' overall bond investment compared to 38% for non-AAM-owned insurers. The L&A industry has increased investment in private bonds, relative to public bonds, to achieve higher yields, while controlling the level of risk. A 2022 study published in Financial Analysts Journal finds that, net of fees, private debt outperforms public investment grade benchmark by 8% and both public high yield and S&P benchmarks by 6% over the period ranging from 1996-2020[14]. Liquidity is more limited for private bonds as these securities are not traded in public markets and investors are often holding the debt to maturity. The illiquidity and structuring risks associated with many types of private bond investments are the key drivers of modestly higher spreads. Furthermore, L&A insurers are well-positioned to take advantage of these illiquidity premiums given that the long-term nature of their liabilities allow insurers to hold assets to maturity, without as great a need for short-term liquidity.

> *"We are enhancing returns through **additional illiquidity and complexity risk, not credit or duration risk**. We have a very advanced risk budgeting process and are doing this in a prudent manner" – AAM Practitioner*

Exhibit 11

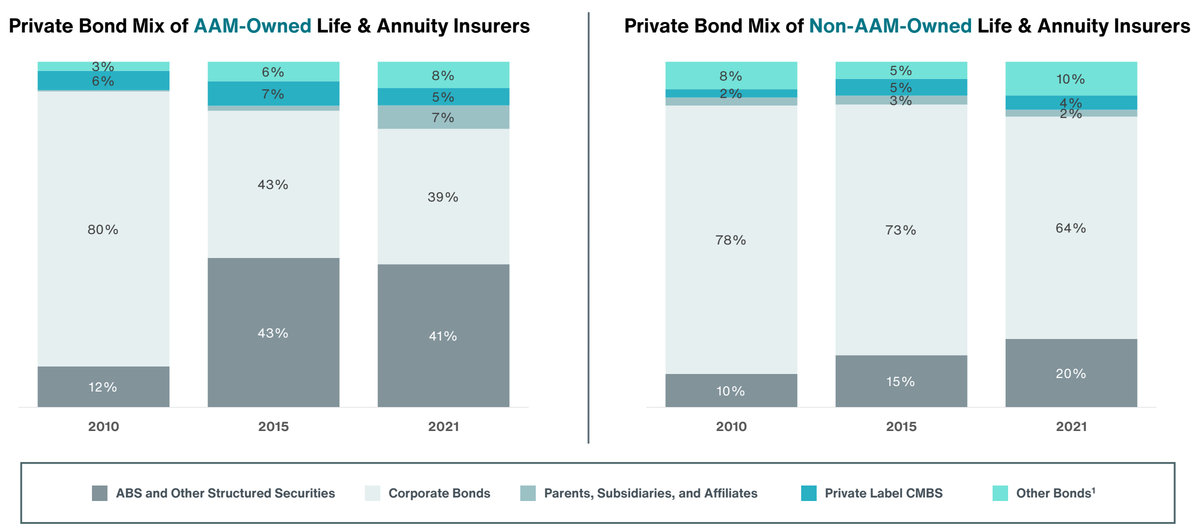
[14] "Private Debt Fund Returns, Persistence and Market Conditions" (June 2022) by Pascal Boni and Sophie Manigart, as published in the Financial Analysts Journal



Source: Aon Inpoint Analysis, SNL Statutory Data

There are further differences around which types of private bonds are held by AAM-owned and non-AAM-owned insurers. As of 2021, AAM-owned insurers had 41% of their private bond portfolio invested in ABS and other structured securities compared to 20% for non-AAM-owned insurers, who had a larger share of corporate bonds (Exhibit 12). Private ABS investment has increased significantly for both groups since 2010, demonstrating the importance of this asset class in slowing the decline of earned income. The public bond portfolio mix of L&A insurers is more similarly distributed in 2021 for AAM-owned and non-AAM-owned insurers as both groups have a high concentration of corporate bonds (Exhibit 13).

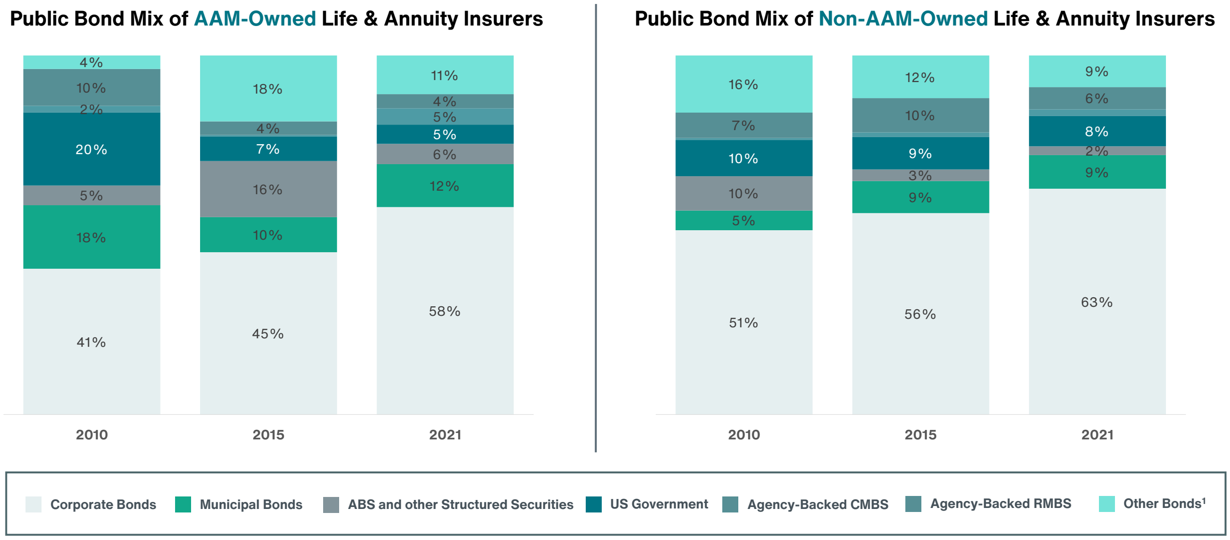
Exhibit 12



Source: Aon Inpoint Analysis of SNL Statutory Data

1. *Other includes the following: Agency-Backed RMBS and CMBS, Bank Loans, BMF and ETF-SVO Identified Funds, Foreign Government Bonds, Hybrid Securities, Municipal Bonds, Parents, Subsidiaries, and Affiliates, Private-Label RMBS, as well as US Government Bonds*

Exhibit 13



Source: Aon Inpoint Analysis of SNL Statutory Data

1. *Other includes the following: Hybrid Securities, Foreign Government Bonds, Parents, Subsidiaries, and Affiliates, BMF-SVO Identified Funds, ETF-SVO Identified Funds, Agency-Backed CMBS, Private-Label CMBS, as well as Bank Loans*

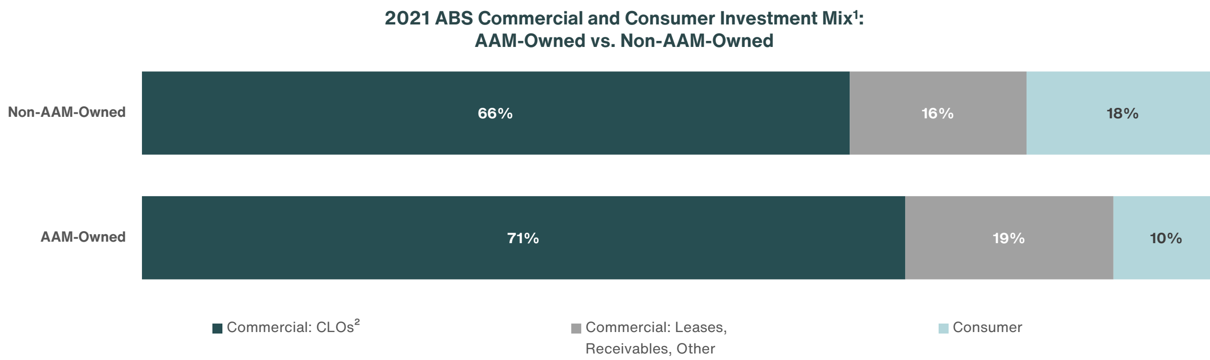
D. ABS: Background, Structure & Default Rates

The losses stemming from the 2008 financial crisis related primarily to mortgage-backed securities (MBS) have led to concerns around the risk levels of other structured securities such as ABS. To examine those concerns, the following section will define ABS, explore embedded structural elements to protect investors, and review studies that compare default rates to similarly rated corporate bonds.

ABS are structured credit investment products that are typically created from the securitization of a pool of fixed income or other assets representing contractual obligations to pay, rather than the underlying asset itself. ABS collateral types can be categorized into two main categories: consumer and commercial. Consumer ABS are backed by cash flows from personal financial assets such as credit card receivables, student loans, or auto loans, while commercial ABS are backed by pools of receivables, loans, or leases on assets, such as shipping containers, data centers, and commercial equipment. Commercial ABS also include CLOs backed by corporate bank debt, collateralized bond obligations (CBOs) backed by a pool of bonds, and collateralized debt obligations (CDOs) backed by mortgage-backed and other asset-backed securities. Both AAM-owned and non-AAM-owned insurers have a majority of their ABS assets in CLOs – 71% and 66%, respectively – relative to commercial leases/receivables and consumer ABS (Exhibit 14)[15].

[15] The CLO category also includes a small number of CBOs and CDOs. According to the NAIC's Collateralized Loan Obligations (CLOs) Primer, "...since the financial crisis, CLOs have continued with new issuance, while CBOs and CDOs have almost disappeared."

Exhibit 14



Source: Aon Inpoint Analysis of SNL Statutory Data

1. *Excludes any undefined transactions*
2. *According to the NAIC, includes a small number of CBOs and CDOs*

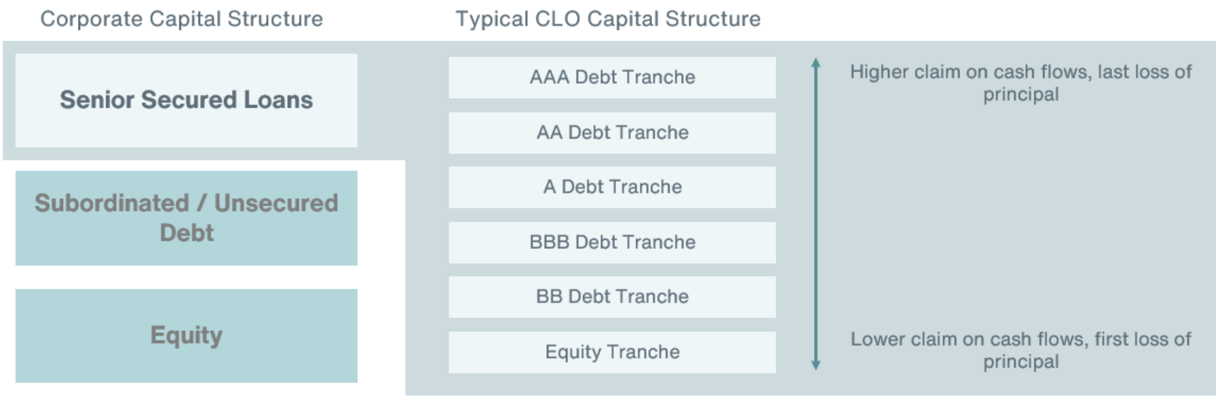
The non-mortgage ABS market has grown to $1.5T and represents approximately 13% of the $11.6T broader structured finance market, which includes residential and commercial mortgage-backed securities, and just 3% of the broader US fixed income market[16]. Increasing investor interest[17] in these securities is attributable to both higher returns as well as the unique characteristics that enhance ABS (and CLO) loss protection for investors, including:

- ABS are comprised of contractual obligations to pay that often rank senior to an individual borrower's other debt obligations, reducing investor exposure if the borrower's financial health deteriorates. CLO structures generally require that at least 90% of the portfolio is invested in senior secured loans.
- The process of securitization generally results in multiple tranches of debt that differ by risk, rating, and timing of repayment. Although the underlying loans themselves may be rated below investment grade, ABS structures include investment grade tranches, which benefit the most from the structure's subordination of cash flows and where L&A insurers concentrate their private bond portfolio. The more junior tranches have a lower claim on cash flow but higher yield. As a result, the formation of tranches aims to create debt that aligns with varying investor preferences. Exhibit 15 illustrates a typical CLO structure.

[16] Guggenheim Partners, "The ABCs of ABS: Identifying Opportunities in Asset-Backed Securities"

[17] Prior to the 2008 financial crisis, CLO yields were generally equivalent to or lower than corporate bond yields, resulting in a lower portion of CLO tranches purchased compared to corporate bonds with the same rating. Post-2008 recession, when yields on CLOs became significantly higher than on comparable corporate bonds, insurance companies began increasing their allocations to the asset class.

Exhibit 15



Source: Guggenheim: Understanding Collateralized Loan Obligations, May 2019

- The pool of underlying loans is typically diversified across many unique borrowers. For instance, CLOs may have over 100 distinct borrowers, which can span across multiple industries with a small percentage of the assets (e.g., 2%) invested in the loans of any single borrower.
- The expected yield of the underlying asset pool usually exceeds the average yield of the issued ABS debt. While this excess spread normally goes to the equity investors, underperformance of the underlying loan pool could trigger the excess spread to be diverted to repay principal of the most senior tranche.
- The principal amount of the underlying pool of loans must be greater than the principal amount issued by the various ABS debt tranches. For example, for every $10 of bank loans in the underlying pool of assets, the ABS might only issue $9 of debt. The difference represents the overcollateralization amount and provides additional cushion for investors.
- ABS managers actively monitor underlying loan portfolios. Covenants exist that require the manager to test the portfolio's ability to cover its interest and principal payments monthly. Tests may include measurement of the interest coverage[18], industry diversification, overcollateralization, etc. Additionally, in many transactions, the manager owns equity or residual interest in the securitization, which generally creates a favorable alignment of interest with the debt investors

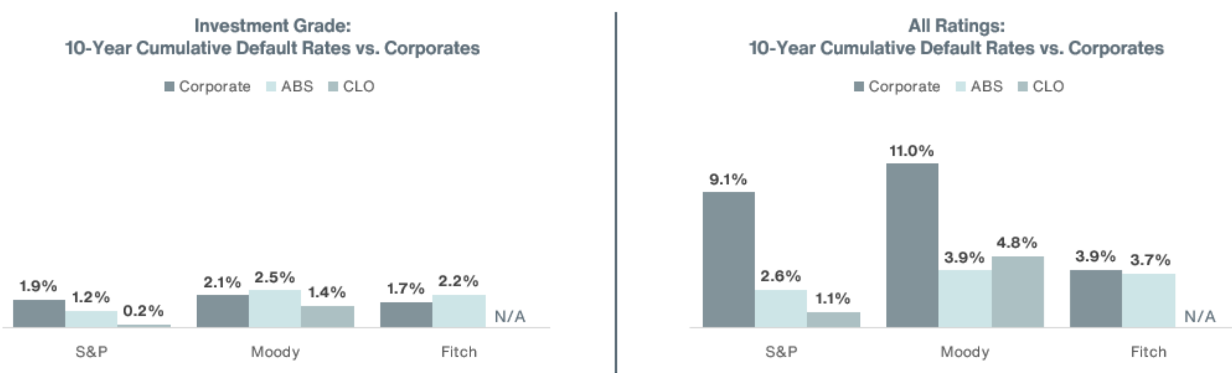
CLOs structures have evolved since their inception in the mid-1990s to reduce their overall risk. The first vintage of CLOs, known as CLO 1.0, included some high yield bonds, as well as loans, and was the standard CLO structure until the 2008 financial crisis. The next vintage, CLO 2.0, began in 2010 with structural changes intended to strengthen credit support, including shortening the

[18] The interest income generated by the pool of assets is compared to and must be greater than the interest due on the outstanding debt.

reinvestment period[19]. In 2014, a new federal regulation known as the Volcker Rule further reduced risk by eliminating high yield bonds from the CLO structure. Although the rule was amended in 2020, allowing high yield bonds back into CLOs, over $400B of CLOs were issued during this period[20]. A limited number of CLOs today include high yield bonds with exposure generally limited to 5%-10% and are compensated for by increased levels of subordination. Also, in response to the 2008 financial crisis, European regulators instituted “Risk Retention” in 2010, which holds that CLO managers must retain 5% of the original value of the assets in their CLOs to align interests more closely with those of investors.

Alongside structural characteristics and recent regulations to protect investors, low default rates for ABS and CLOs further support the low risk profile of this asset class. Based on 10-year cumulative data from S&P, Moody’s, and Fitch, investment grade CLOs have consistently lower default rates relative to equivalently rated corporates, whereas ABS default rates are more similar (Exhibit 16). In 2021, the US ABS market had just three defaults stemming from student loan and manufactured housing subsectors in the high yield 'B' and 'CC' rating categories and no defaults in investment grade ABS[21] which is where AAM-owned L&A insurers focus their allocations. CLOs have shown resilience during the COVID-19 pandemic, where global CLO default rates dropped to the lowest level since 2008 while the default rate of corporate issuers increased[22].

Exhibit 16



Source: JP Morgan, “Analysis of Historical NRSRO Ratings Data”, 2022

Furthermore, a 2021 study conducted by the Federal Reserve Bank of Philadelphia examined the performance of CLOs by tranche and concluded that “...over the history of the CLO market, debt

[19] Defined as the two-to-five-year period during which the CLO manager is able to buy and sell new loans using the principal cash flows. Once the reinvestment period has ended, the CLO manager pays down the debt tranches. Issuing a CLO with a shorter reinvestment period ensures investors get their money back more quickly.

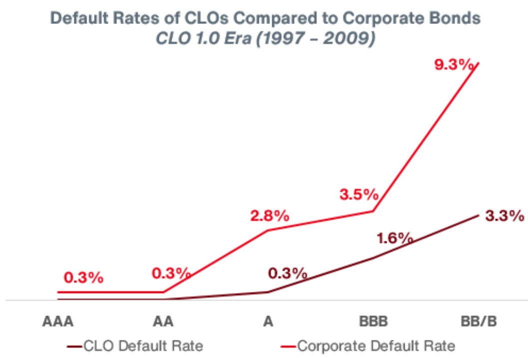
[20] Wall Street Journal, “CLOs Wrap Up Record Year”

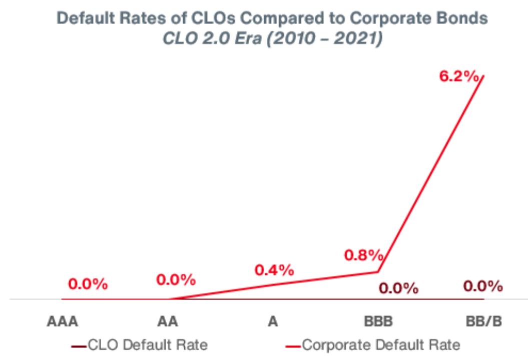
[21] S&P Global Rating Research, “Default, Transition, and Recovery: 2021 Annual Global Structured Finance Default and Rating Transition Study”

[22] S&P Global, “Default, Transition, and Recovery: 2020 Annual Global Leveraged Loan CLO Default and Rating Transition Study”

tranches experience significantly lower default rates than similarly rated corporate bonds. This evidence implies that any mistakes in rating CLOs are as yet unrealized, despite two significant economic crises in our sample period" [23] (Exhibit 17).

Exhibit 17





Source: CLO Performance Analysis Study by the Federal Reserve Bank of Philadelphia, November 2021

E. Bond Ratings

Credit rating agencies received significant scrutiny as the economy emerged from the 2008 financial crisis, resulting in regulatory reforms intending to improve their reputation and reliability. The Dodd-Frank Wall Street Reform and Consumer Protection Act enhanced SEC regulation of credit rating agencies, which subsequently imposed stricter requirements such as enhanced reporting. In response, rating agencies began disclosing their ratings methodology to offer greater transparency, updated their compliance policies and expanded compliance staffing, added independent board members to approve internal procedures and rating methodologies, and focused on providing more consistent ratings across industry segments.

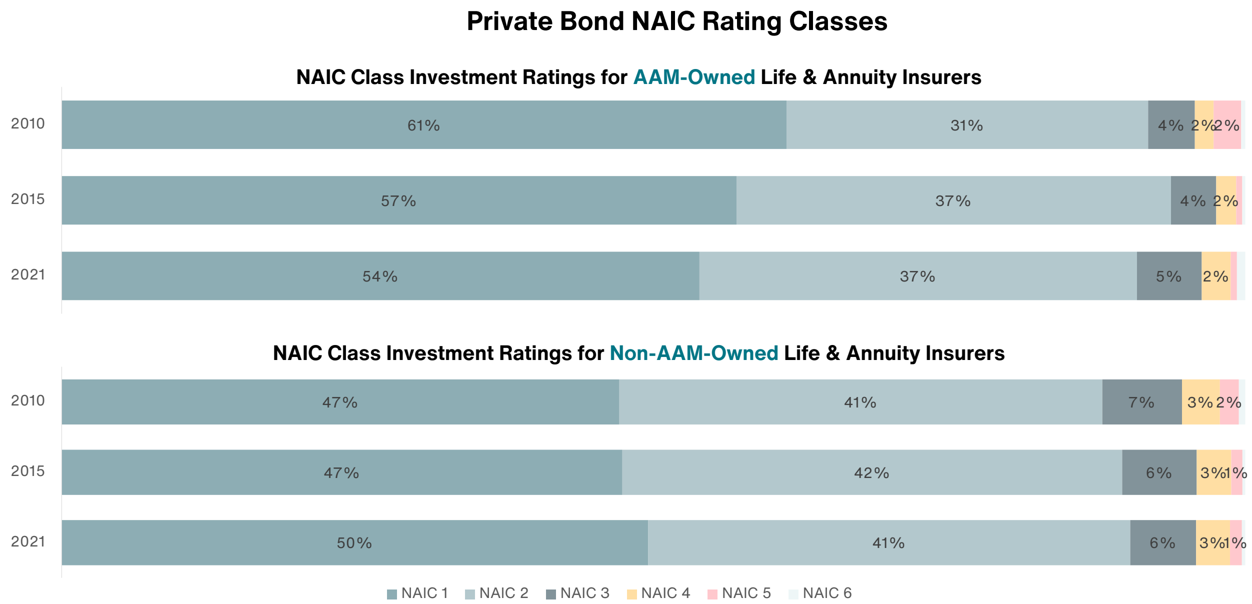
The credit ratings of private and public bond portfolios remain very similar between AAM-owned and non-AAM-owned insurers (Exhibits 18 and 19), indicating that the different investment mix previously discussed between these groups likely does not translate to a lower quality portfolio. The NAIC has historically segmented bond investments into six rating classifications based on their credit ratings with 1 being the highest quality (AAA to A-) and 6 (below CCC-) the lowest[24]. These credit ratings are either provided by independent credit ratings agencies or, for unrated bonds, the NAIC, which conducts their own credit analysis. Since 2010, AAM-owned and non-AAM-owned

[23] Federal Reserve Bank of Philadelphia, "Philadelphia Federal Reserve Study on CLO Performance Over Time"

[24] As of 2022, NAIC bond rating classifications have expanded from six to twenty, as outlined in Section G

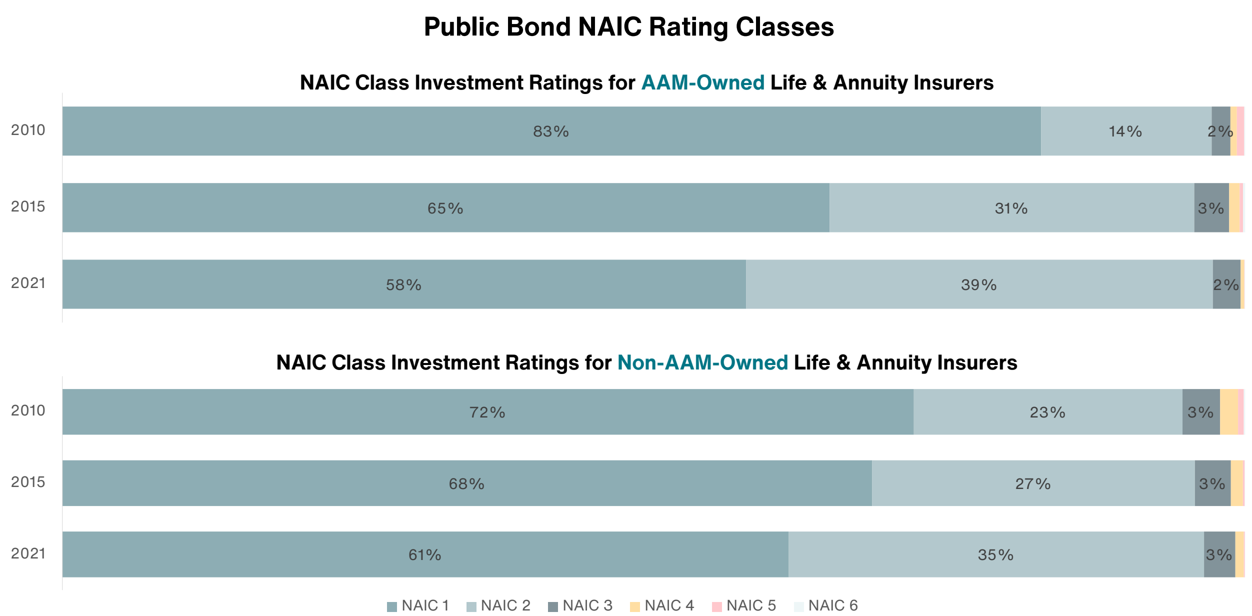
insurers have had greater than 90% of private and public bond investments in NAIC classes 1 and 2, considered to be investment grade[25].

Exhibit 18



Source: Aon Inpoint Analysis, SNL Statutory Data

Exhibit 19



Source: Aon Inpoint Analysis, SNL Statutory Data

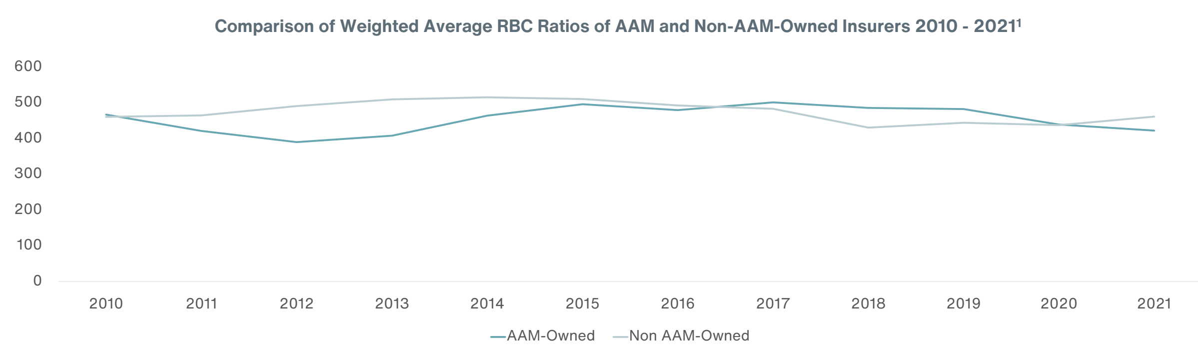
25 NAIC 1 rating is equivalent to S&P ratings AAA to A-. NAIC 2 rating is equivalent to S&P ratings BBB+ to BBB-

F. Regulatory Oversight and Corporate Governance

Regardless of ownership structure, all insurers are subject to a consistent and comprehensive regulatory regime designed to protect policyholders. The NAIC and individual state insurance departments continually monitor and evaluate the evolving landscape. The system has been tested, refined, and strengthened by lessons learned from past recessions and, most recently, the COVID-19 pandemic. Regulators collect significant disclosures from insurers to monitor asset quality and solvency levels and to assess an insurer's compliance with existing federal and state statutes and regulations, including the investment limitations that exist within those laws. Regarding CLOs, the NAIC has performed multi-scenario stress tests on industry CLO portfolios and in 2020 concluded "US insurer investments in CLOs remain an insignificant risk"[26]. L&A insurers must perform cash flow testing as well as asset and liability matching to demonstrate to regulators the assets held will be sufficient to cover future liabilities. The NAIC modifies the requirements and parameters for these tests in response to changing trends in investment portfolio composition. They are currently in process of developing new actuarial guidelines to address the rise in investment complexity in life insurers' portfolios[27].

Risk Based Capital (RBC) is a metric used by regulators to ensure that insurers hold capital in proportion to the risk they take on. This ratio is calculated based on the size of the company as well as the inherent riskiness of its financial assets. Company Actional Level (CAL) RBC ratios above 100% are safe from regulatory intervention. Historically, AAM-owned and non-AAM-owned insurers have maintained comparable weighted average CAL RBC ratios between 400% and 500% (Exhibit 18).

Exhibit 20



Source: Aon Inpoint Analysis of SNL Statutory Data

1. *RBC refers to company action level RBC. Weighted average calculation based on each insurer's total cash and invested assets*

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[26] National Association of Insurance Commissioners, "Collateralized Loan Obligation (CLO) – Stress Testing U.S. Insurers' Year-End 2020 Exposure"

[27] For more information on NAIC oversight related to AAMs, see the NAIC response letter (May 31st, 2022) to Chairman Sherrod Brown, U.S. Senate Committee on Banking, Housing, and Urban Affairs

AAM-owned (and non-AAM-owned firms) are governed by sophisticated internal risk management policies to protect against potential risks across their portfolio. This includes regular testing to ensure that they are not forced to sell during market volatility, as well as liquidity coverage ratios that require sufficient liquidity to meet policyholder demands. Additionally, many of the larger AAMs are public companies with independent boards and are subject to additional reporting and regulatory requirements. Both insurance companies and large AAMs have public disclosure requirements for their financials which they report to the SEC, NAIC, and state regulators, to ensure transparency.

> "[AAM] ***regularly stresses its asset portfolio*** *and would expect* ***no principal impairment on its CLO debt portfolio in a 'Base Recession' scenario****, which utilizes more punitive stress assumptions for CLOs than experienced during the Financial Crisis*." – AAM Practitioner

In addition to an evolving insurance regulatory landscape, AAMs must be aware of and monitor a dynamic regulatory environment in the investment management marketplace as well. The Securities and Exchange Commission (SEC) is an independent federal agency that is headed by a five-member commission who act jointly to set and enforce the rules that govern the securities markets and its participants which include securities exchanges, securities brokers and dealers, investment advisers, and mutual funds. AAMs, under the Investment Advisers Act of 1940 as private fund advisers, fall within the SEC's remit and are required to register with the SEC or applicable state securities regulators as registered investment advisers (RIAs). In addition to AAMs being subject to the SEC's oversight as RIAs, their private fund capital raising from investors, primarily through 506(b) (private placements) and 506(c) (general solicitation offerings), must fall within an exemption from SEC registration under the Securities Act of 1933.

G. Investment Outlook

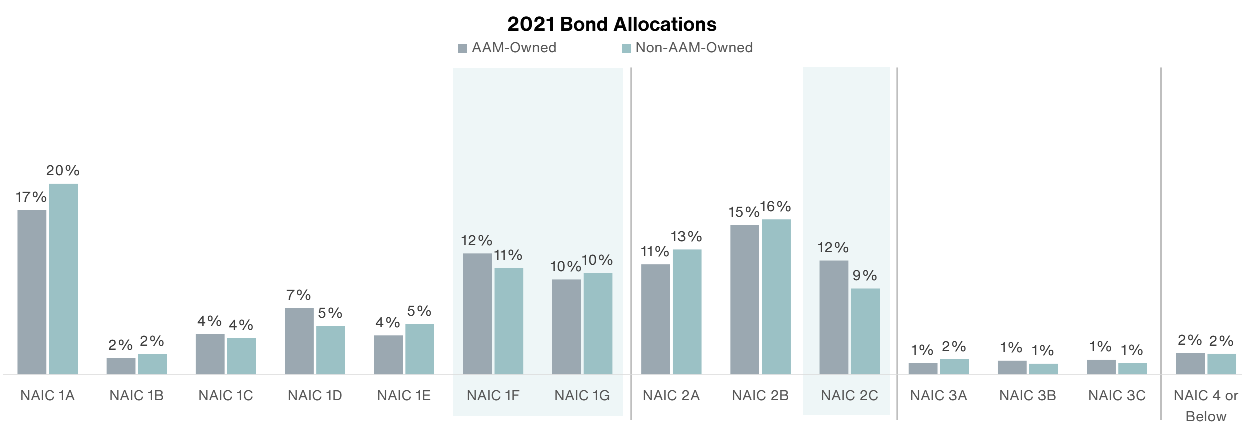
Rising interest rates may take some pressure off the industry to deploy funds into higher-yielding investments like privately placed bonds, commercial mortgages, etc. However, the appetite for these assets is unlikely to dissipate given the desire for incremental yield and potential spread widening.

> *"…* ***continue to focus on directly originated, privately negotiated, primarily investment grade-rated investment opportunities*** *that seek to generate a premium book yield to the traditional public, liquid markets, while seeking to minimize incremental investment/credit risk." – AAM Practitioner*

From a regulatory perspective, the NAIC recently introduced and is considering several modifications that may have an impact on insurer portfolios over time. In 2021, the NAIC released a set of changes that lowered the risk-based capital requirements for Schedule A real estate investments (properties owned outright by insurers) from 15% to 11% as well as for Schedule BA real estate from 23% to 13%. According to AM Best, the American Council of Life Insurers advocated for this change given that the capital reserves were established three decades ago, and their members have since developed a positive track record of investing in the sector[28]. These changes may create a modest tailwind for additional long-term investments into these asset classes, however the capital requirements remain higher than bonds and other investments.

Starting in 2022, NAIC rating distinctions have expanded from six to twenty C-1 bond factors to provide a more thorough differentiation between credit ratings and their associated risk-based capital charges. Exhibit 21 shows the allocation of insurers' 2021 bond investments and their corresponding rating classes under new NAIC guidance. The data shows minor differences between both AAM-owned and non-AAM-owned insurers, with the former allocating 1-3% more of their bonds to lower rated, higher yielding investments that still qualify for the broader NAIC Class 1 and 2 ratings. With the widening of ratings classifications, those lower quality NAIC 1F and NAIC 1G investments will receive a higher capital charge relative to the highest quality NAIC 1A investments. L&A insurers, regardless of ownership structure, may over time reexamine the distribution of bonds across their portfolios as they adjust to new RBC charges.

Exhibit 21



Source: Aon Inpoint Analysis, SNL Statutory Data, NAIC

[28] AM Best, "NAIC Revisions to Capital Requirements Widen Opportunities for Real Estate Investments by Life Insurers"

V. Conclusion

AAMs have played an important role in the L&A industry for decades by seeking to improve operations, providing specialized investment capabilities, enhanced investment returns, and asset origination. With declining yields over recent years from the historically low interest rate environment, insurers and AAMs increasingly gravitated to one another via reinsurance agreements, asset sales, selling entire operations, or establishing strategic investment management agreements. AAMs have become an important source of funding (and in some cases the only source) for many of these transactions, and have generally reduced solvency risk via enhanced yields, which may benefit insurers and policyholders. This may free up insurers' cash for higher ROI investments. Insurers also benefit from AAM's private credit investing capabilities. Looking forward, for these reasons, the partnership between AAMs and L&A insurers is expected to continue despite increasing interest rates taking pressure off the search for yield and near-term economic uncertainty potentially reducing M&A volumes.

The investment portfolios of AAM-owned and non-AAM-owned insurers are relatively similar across major asset classes, including alternative assets in Schedule BA (e.g., Hedge funds, Private Equity, etc.). The most significant investment allocation difference is that AAM-owned insurers are more heavily concentrated in private bonds, specifically ABS (e.g., CLOs). Since 2010, both groups have shifted a significant portion of private bond investment away from corporate bonds and into ABS, which can achieve higher yields due to increased structuring and illiquidity risk, rather than credit risk. AAM-owned insurers changing investment mix and larger ABS concentration coincides with consistent outperformance (+20 bps) on overall bond earned income since 2015, compared to non-AAM-owned insurers.

Concerns regarding ABS arose in the marketplace in the years following the 2008 financial crisis given the losses stemming from MBS. However, given comparable default rates to corporate bonds, structures that include several investor protections, on-going monitoring and stress-testing by insurance regulators and insurers, and the high concentration of private bonds in lower-risk investment grade tranches, it appears that that these AAM-owned insurer portfolios maintain a similar risk level to non-AAM-owned insurers. Additionally, it is anticipated that growth in ABS, and private credit more broadly, will continue across the entire L&A industry given the risk profile and investment returns, which may lead to more competitive solutions for policyholders.

VI. Methodology

AAM-owned Portfolio Analysis

Aon Inpoint identified all L&A insurers that operated between 2010-2021 using S&P Capital IQ Insurance Statutory Financials. We then constructed an original dataset of AAM-owned L&A insurers and indicated which years they were either "AAM-owned" or "non-AAM-owned". The AAM ownership information was collected from a combination third party sources (SNL, AM Best, NAIC, etc.) as well as significant manual company research that included reviewing quarterly LIFE-QS and LIFE-AS regulatory filings, which detail organizational charts (Schedule Y) that disclose ownership stakes of major investors. Since individual insurance firms are often subsidiaries of holding companies, an insurance entity was considered AAM-owned if the holding company has one or more AAM investors with a majority interest. Additionally, if a non-AAM-owned insurer has a publicly identifiable Investment Management Agreement (IMA) in place with an AAM and some level of equity ownership, they were considered "AAM-owned" for the purpose of analyzing portfolio allocations.

L&A M&A Volumes

Using the list of AAM-owned entities identified above as a starting point, Aon Inpoint used a combination of proprietary Aon research, S&P Capital IQ Transactions dataset, news publications, and other third-party sources to identify transaction values representing AAM-owned insurance entities with greater than 50% equity. Using that transaction data, we conservatively estimated additional investment for the remaining transactions without disclosed deal values. This analysis excludes any transactions between AAMs for L&A entities.

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