

MONTSHIRE
ADVISORS

2013 Private Placement Life Insurance Conference

SOLUTIONS ADVICE EXPERIENCE

Focused exclusively on the insurance industry

About Montshire Advisors



- ◆ **Montshire Advisors is a solution oriented advisory firm serving the insurance industry. The company was formed in late Q1 2012.**
- ◆ **We market alternative asset management strategies to insurers through tax and capital efficient structures such as corporate owned life insurance and as general account investments**
- ◆ **We also work with both insurance carriers and various types of producers to create non-traditional insurance distribution opportunities and to provide general corporate finance advice**
- ◆ **Montshire Advisors is a solution oriented advisory firm serving the insurance industry and is led by its experienced principals:**
 - **Ed Parry : Former CFO of Hanover Group, formerly Allmerica Financial, and of National Life Group.**
 - **Bob Alban: Former head of corporate development and M&A for National Life Group and Sentry Insurance**

Insurer Owned Life Insurance Introduction



- ◆ Insurer Owned Life Insurance, also known as I-COLI or IOLI refers to life insurance purchased by insurance companies on a group of it's eligible key employees.
- ◆ The I-COLI market has traditionally focused on fixed crediting rate or stable value wrapped product; however in the current low return environment such products are unavailable or unattractive.
- ◆ Currently, the market is focused on private placement life life ("PPLI") format (separate account) I-COLI products.
- ◆ I-COLI is very effective as a tax and capital efficient vehicle to wrap invested assets.
 - Especially attractive vehicle for insurers to wrap their high return / high risk charge alternative asset classes

Insurer Owned Life Insurance

What is it?



- ◆ **I-COLI basics**
 - The company pays the premium and is the owner and beneficiary of the insurance policies
 - Used to fund deferred compensation or other employee benefit obligations or as a wrap for general account investments
 - Guaranteed issue underwriting
 - Designed to have initial cash value equal to premium paid (issuing carrier finances upfront charges)
 - Typically designed to be a single premium MEC
 - Half dozen or so carrier provide this product

- ◆ **Tax benefit**
 - As long as simple safe harbors are followed, increases in cash surrender value are tax deferred, and death benefits are received tax free

- ◆ **Capital benefit**
 - The regulatory and rating agency capital models assess a relatively low counterparty risk charge for I-COLI, not a asset risk charge on the assets in the separate account

Hypothetical I-COLI Economics



Hypothetical \$100M Size I-COLI Program – Income Impact

	Taxable Investment (\$M)	PPLI - COLI (\$M)	Annual Enhancement to Income and Surplus (\$M)
Investment return @ 7%*	\$ 7.00	\$ 7.00	
Taxes due @ 35%	2.45	-	
After-tax return	4.55	7.00	
Insurance expense	-	0.80	
Net Income	\$ 4.55	\$ 6.20	\$ 1.65

Hypothetical \$100M Size I-COLI Program – S&P Capital Impact

	Own Directly	Own through PPLI**	Enhancement (\$M)
\$25M High Yield Debt	\$ 10.31	\$ 0.38	
\$25M Common Stock	9.50	0.38	
\$25M Hedge Fund	9.50	0.38	
\$25M Private Equity	9.50	0.38	
Total S&P Capital Required (A-level)	\$ 38.81	\$ 1.50	\$ (37.31)

Actual tax benefit will depend on the purchaser's actual investment return and tax rate. Capital benefit illustrates impact from S&P capital model. Similar benefits exist under AMBest BCAR model and regulatory RBC model.

**Net of asset management fee;*

***Charges based on COLI issued by A-rated carrier*

Insurer Owned Life Insurance Market Snapshot



- ◆ At the end of 2012, there was over \$16 billion in I-COLI in-force
 - 23 insurance companies own \$100M or more

- ◆ Much of this in-force I-COLI was sold in the 90's
 - Reciprocal deals – two insurers buy each other's COLI product
 - BOLI brokers leveraging relationships with BOLI issuing carriers
 - Carriers bought their own COLI policies

- ◆ The majority of the in-force I-COLI is general account or stable value wrapped

- ◆ Post 2008
 - Stable value wrap was no longer made available
 - General account capacity dried up
 - Market focused more on separate account product

- ◆ Recent activity
 - 2012: 4 life insurers purchased in aggregate \$320 million
 - 2011: 3 life insurers and 2P&C insurers purchased in aggregate \$450 million

I-COLI Market vs. BOLI Market



- ◆ BOLI is a highly penetrated market, on the other hand, the i-COLI market is much less penetrated.

<u>Financial Service Industry</u>	<u>BOLI /COLI owned (\$B)</u>	<u>Total Capital</u>	<u>BOLI /COLI owned (% of total capital)</u>	<u>BOLI / COLI Regulatory Capital Treatment</u>	<u>2012 Industry Effective Tax Rate</u>	<u>2007 Industry Effective Tax Rate</u>
Bank and Thrift	\$140 billion	\$1,544 billion	9.1%	Asset risk charge based on look through to underlying investments	32%	30%
Life Insurers	\$11 billion	\$314 billion	3.6%	No risk charge	17%	26%
P&C Insurers	\$3 billion	\$562 billion	0.5%	Flat risk charge regardless of underlying investments	14%	24%
Health Insurers	<\$1 billion	\$107 billion	0.4%	Flat risk charge regardless of underlying investments	31%	31%

I-COLI Market Challenges



- ◆ **Institutional life insurance grew up around banks, not insurance companies**
 - Specific BOLI products / no specific I-COLI products
 - Specialized BOLI brokers / only one specialized I-COLI broker
 - Specific regulatory guidance on BOLI / no specific regulatory guidance on I-COLI

- ◆ **Fear and uncertainty slow the development of this market**
 - 2006-2007 tax uncertainty –Post issuance of 2006 Pension Protection Act until Revenue Ruling 2007-61
 - Corporate tax reform noise
 - Concern that rating agencies could change their position on capital charges

- ◆ **Other objections**
 - Mark-to-market; income statement volatility
 - Perceived competitive threat of buying insurance product of another insurance company
 - Dislike for insuring the lives of employees
 - In AMT (especially P&C carriers)
 - Executive compensation based on pretax income
 - Multiple decision makers involved / competing priorities

The Future of the I-COLI Market



- ◆ The market potential is large, - \$25 billion over the next five years
- ◆ Low return environment is forcing insurance CIOs to look for alternative asset classes where I-COLI can provide substantial benefits.
- ◆ Montshire is working jointly with select asset managers to develop this market
 - Asset managers cannot look to brokers solely to source deals rather as subject matter experts on structuring
- ◆ Montshire is working to restructure underperforming in-force COLI including reallocating into more attractive investment options.
- ◆ Montshire is working to develop specific products to target this market.
 - Including annuity structures that are more transactional
 - Including structures that dampen market to market volatility
- ◆ General account I-COLI is dead for the foreseeable future
- ◆ Together as broker, asset manager, fund administrator, and legal counsel, we need to engage the industry in thoughtful and conversation in order to successfully realize the potential for this market.



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Appendices

I-COLI vs. Direct Investment



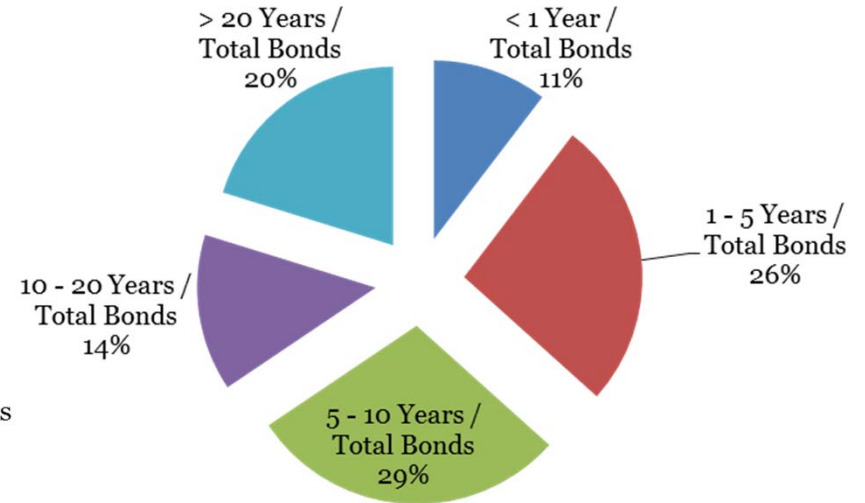
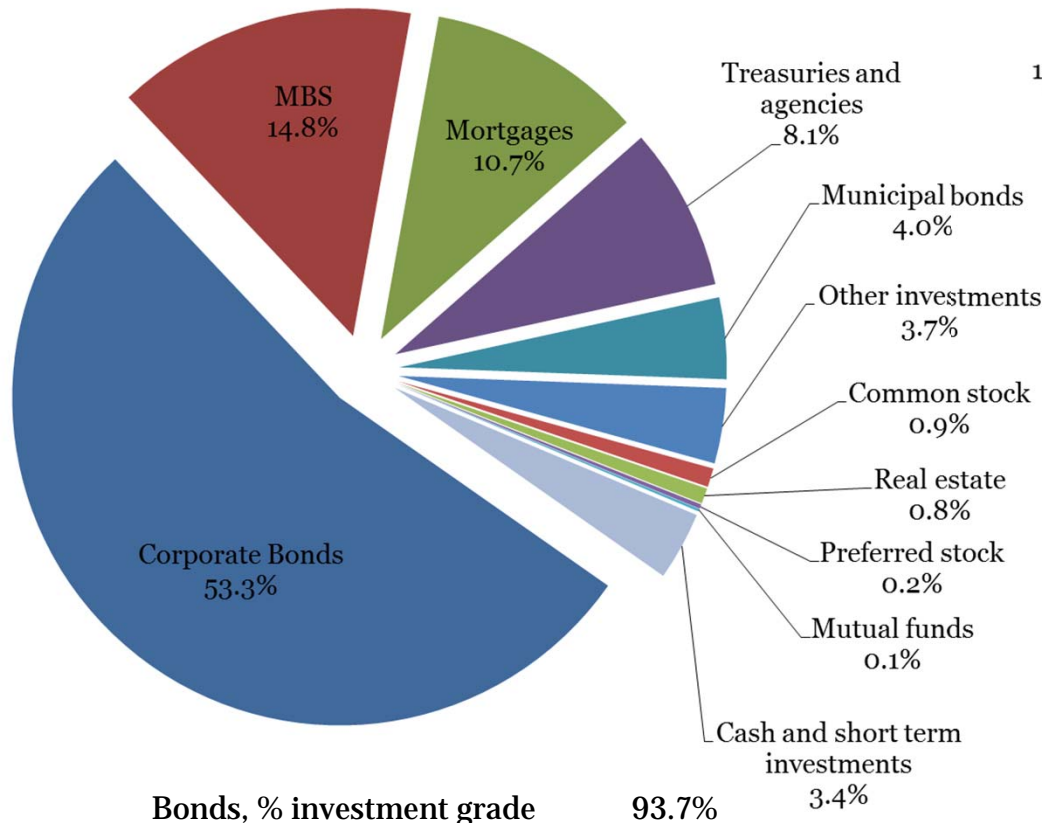
- ◆ The following illustrates the different accounting and capital treatment of I-COLI investment versus direct investment:

	Separate Account I-COLI	Hedge Fund / Private Equity / Equity	Fixed Income
Statutory Accounting	<ul style="list-style-type: none"> • Booked as other than invested asset. • Held at cash surrender value. • Changes in cash surrender value booked as other income. 	<ul style="list-style-type: none"> • Booked as invested asset. • Held at market value. • Changes in market value flow through statutory capital (not income). 	<ul style="list-style-type: none"> • Booked as invested asset. • Held at book value. • Income amortized through investment income. • Changes in market value do not affect income or balance sheet.
GAAP Accounting	<ul style="list-style-type: none"> • Booked as other than invested asset. • Held at cash surrender value. • Changes in cash surrender value booked as other income. 	<ul style="list-style-type: none"> • Booked as invested asset. • Held at market value. • Changes in market value flow through balance sheet other comprehensive income account. 	<ul style="list-style-type: none"> • Booked as invested asset. • Held at book value. • Income amortized through investment income. • Changes in market value do not hit income or balance sheet.
Tax	<ul style="list-style-type: none"> • No tax if held to completion. 	<ul style="list-style-type: none"> • Income and realized gains are taxed. 	<ul style="list-style-type: none"> • Income and realized gains are taxed.
Capital	<ul style="list-style-type: none"> • Counterparty risk charge 	<ul style="list-style-type: none"> • Asset risk charge - equity 	<ul style="list-style-type: none"> • Asset risk charge - other

Life Insurer Investment Strategy



US Life Insurance Industry Aggregate Asset Allocation, 12/31/12
Based on \$3.2 Trillion Non-Affiliate Investments



Concerns / Trends

- ◆ Long duration fixed income portfolio will incur significant losses in rising rate environment
- ◆ Looking for yield; higher return assets
- ◆ Limited to access higher return assets due to high capital charges

Bonds, % investment grade 93.7%

Montshire analysis of SNL Financial Data

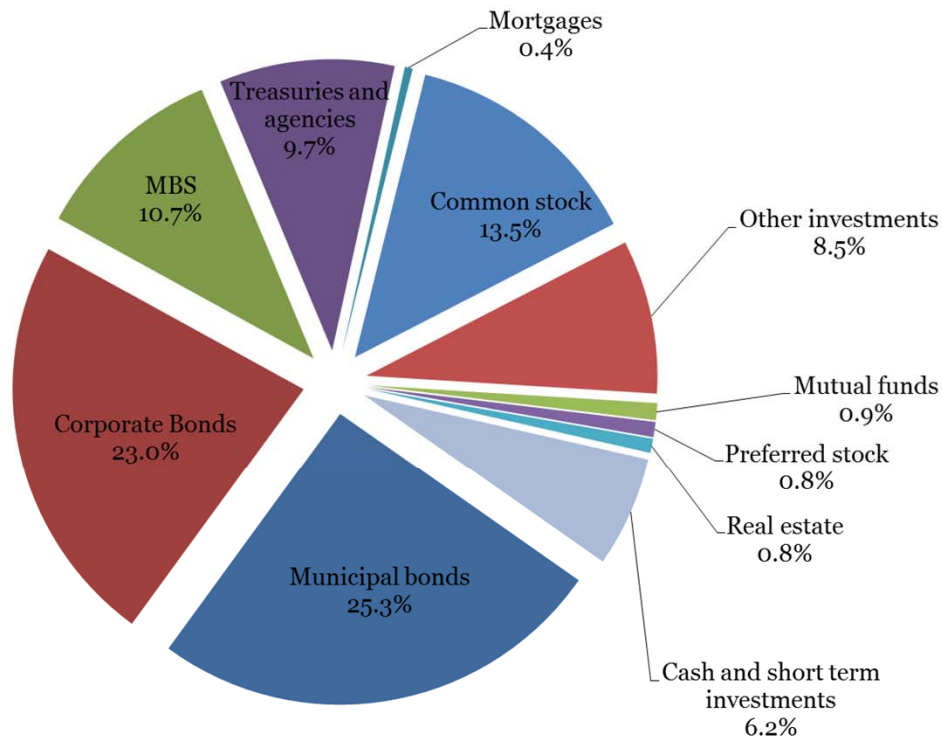
Property & Casualty Insurer Investment Strategy



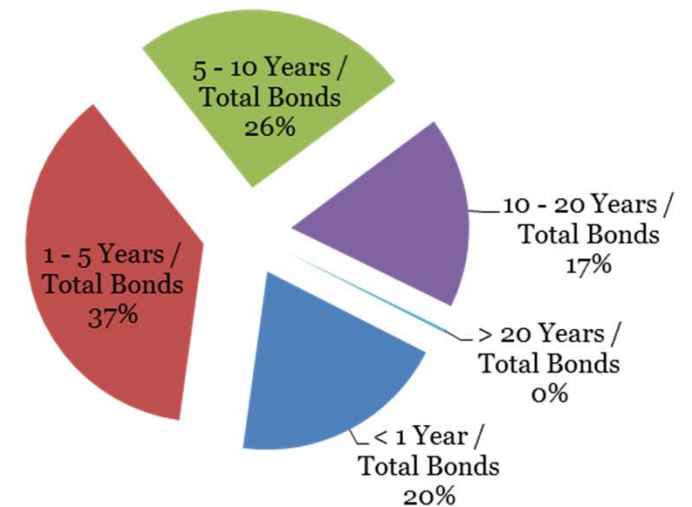
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US P&C Insurance Industry Aggregate Asset Allocation, 12/31/12

Based on \$1.3 Trillion Non-Affiliate Investments



Bonds, % investment grade 95.9%



Concerns / Trends

- ◆ Bifurcated portfolio – assets backing liabilities strategy focus on liquidity; assets backing surplus are focused on risk taking
- ◆ Looking for yield; higher return assets; duration
- ◆ Concerned about inflation
- ◆ Concerned about rising rates and associated losses to fixed income portfolio
- ◆ Very few have derivative use plans in place

I-COLI Investment Strategy



- ◆ Asset classes that make sense in I-COLI separate account should have some or all of the following characteristics:
 - Low volatility
 - High returns (tax savings needs to cover insurance costs)
 - Low correlation to investment grade fixed income and equities
 - Positive correlation to inflation and interest rates
 - High capital charges if owned directly
 - Tax inefficient

- ◆ Example asset classes for I-COLI:
 - CLOs and bank loans
 - Direct lending / mezzanine debt
 - Short duration high yield fixed income
 - Some hedge funds
 - REITS
 - MLPs