

MEMORANDUM

To: File No. S7-41-11

From: Jennifer B. McHugh
Senior Advisor to the Chairman

Date: May 4, 2012

Re: Meeting with National Association of Insurance Commissioners (“NAIC”)

On April 26, 2012, representatives from the NAIC met with Chairman Mary L. Schapiro and Jennifer B. McHugh, Senior Advisor to the Chairman. The NAIC participants were NAIC President, Kevin McCarty (Florida insurance commissioner), Julie McPeak (Chair of the NAIC Life/Annuities committee and Tennessee commissioner) and Ethan Sonnichsen, NAIC Director of Government Relations.

Among other issues, the representatives from the NAIC referenced their February 10, 2012 comment letter on the Volcker Rule proposal, available at <http://www.sec.gov/comments/s7-41-11/s74111-190.pdf>. Following the meeting, the NAIC provided the attached Capital Markets Special Report.



Capital Markets Special Report

Schedule BA – Private Equity and Hedge Funds

The Capital Markets Bureau's Special Report dated as of Sept. 23, 2011, looked at the U.S. insurance industry's Schedule BA investments, or "Other Long-Term Invested Assets." This Special Report takes a closer look at insurers' private equity and hedge fund investments as reported in Schedule BA as of year-end 2010.

Summary

The insurance industry's general account cash and invested assets at year-end 2010 totaled \$5 trillion in book/adjusted carrying value (BACV), of which Schedule BA accounted for \$232.6 billion (or 4.3%). Among those Schedule BA investments, \$61.6 billion (or 1.24%) were designated as private equity and hedge funds. At this percentage, reported private equity and hedge fund exposures were not material to regulated U.S. insurance companies. The investments of domestic insurers in hedge funds and private equity funds also do not appear to be material as a percentage of the total private equity and hedge fund market.

Only 372 of the 4,455 U.S. insurance companies reported private equity or hedge fund investments. Such investments were significant in relation to capital for only a few dozen companies. Of the total, \$48.3 billion (or 0.97% in cash and invested assets) was designated as private equity funds and \$13.4 billion (or 0.27%) as hedge funds. In addition, there are investments listed on Schedule BA not designated as a hedge fund or private equity fund, but with the same managers as those designated as either hedge funds or private equity funds. These totaled approximately \$23.3 billion as of year-end 2010.

Insurers' Private Equity and Hedge Fund Investments by Strategy

This report focuses on those private equity and hedge fund investments reported with one of 13 private equity or hedge fund "Type and Strategy" designations in Schedule BA, Part 1, column 9, pursuant to the 2010 *Annual Statement Instructions*. The designations are as follows:

Private equity

- Venture capital
- Mezzanine financing
- Leveraged buyout (LBO)

Hedge fund

Global macro
Long/short equity
Merger arbitrage
Fixed-income arbitrage
Convertible arbitrage
Futures/options/foreign exchange arbitrage
Sector investing
Distressed securities
Emerging markets
Multi-strategy

Private equity funds and hedge funds are generally illiquid with significant restrictions on transferability. In addition, private equity funds can only distribute cash when underlying investments, which are themselves illiquid, can be sold. Hedge funds are structured more as trading portfolios and offer investors some ability to request withdrawals at current market values. While many hedge funds offer quarterly or annual liquidity, “gates” and “side-pockets” limit redemptions, and some funds have multi-year lock-ups.

Insurers reported that \$61.6 billion of private equity and hedge fund BACV was distributed among the 13 different designated investment types and strategies (as shown in Table 1 below). Life companies accounted for 67% and property/casualty companies accounted for 29% of the industry’s private equity and hedge fund investments.

Table 1: Insurers’ Private Equity and Hedge Fund Investments (\$millions)

BACV by Strategy	Life		P&C		Futures		Health		Total	
Venture Capital	\$5,827	10%	\$2,064	20%	\$20	2%	\$499	79%	\$13	7%
Mezzanine	7,008	14%	1,339	9%	208	17%	0	0%	0.00	0%
Leveraged Buyout	20,101	34%	4,751	27%	1,374	79%	13	2%	0.00	0%
Private Equity	\$34,687	84%	\$11,374	64%	\$1,706	98%	\$512	82%	\$1	74%
Global Macro	\$299	1%	\$533	3%	-	-	-	-	-	-
Long/Short Equity	1,916	4%	1,739	10%	-	-	104	16%	-	-
Merger Arbitrage	27	0%	92	1%	-	-	-	-	-	-
Fixed Income Arbitrage	377	1%	53	0%	-	-	-	-	-	-
Convertible Arbitrage	48	0%	86	0%	-	-	-	-	-	-
Futures, Options	3	0%	100	1%	-	-	-	-	-	-
Sector	113	0%	206	1%	-	-	-	-	-	-
Distressed	1,227	3%	636	3%	-	-	-	-	-	-
Emerging Mkts	181	0%	147	1%	-	-	-	-	-	-
Multi-Strategy	2,712	7%	2,722	13%	27	1%	13	2%	0.00	0%
Hedge Funds	\$6,702	16%	\$6,507	36%	\$27	2%	\$116	18%	\$0	26%
Total	\$41,399	100%	\$17,880	100%	\$1,736	100%	\$628	100%	\$1.7	100%
% of Total Industry	67%		29%		3%		1%		0%	

Of the 4,455 U.S. insurance companies in the NAIC’s 2010 database, only 1,163 had Schedule BA investments and (as mentioned previously) only 372 reported private equity or hedge fund investments. The combined cash and invested assets of these 372 insurers was \$3.21 trillion, for an overall average allocation to private equity and hedge funds of 1.9%.

Among these 372 companies, the 20 largest insurance groups or holding companies held \$48 billion (or 80%) of the industry’s private equity and hedge funds in 2010. Thirty-four companies reported private equity and hedge fund BACV exceeding 20% of their capital and surplus. Twelve companies accounted

for \$31.8 billion (or 51.6%) of all such funds; they had a combined \$1.1 trillion in cash and invested assets.

Overall, private equity and hedge funds reported as “affiliated” accounted for only \$10 billion (or 16.2%) of all such investments, of which 70% was in the three private equity strategies and 24% were in multi-strategy hedge funds.

“Type and Strategy” Investments Over Time

The following table shows how the insurance industry’s private equity and hedge fund investments, by dollars and designated type and strategy, have evolved over the past six years.

Table 2: Insurers’ Private Equity and Hedge Fund Investments Over Time (\$millions)

BACV by Strategy	2005	2006	2007	2008	2009	2010
Venture Capital	\$5,919	\$6,139	\$11,323	\$10,733	\$10,330	\$12,426
Mezzanine	3,391	5,050	3,967	8,726	9,413	9,332
Leveraged Buyout	9,409	13,594	19,313	18,596	21,233	26,329
<i>Private Equity</i>	<i>\$18,799</i>	<i>\$26,783</i>	<i>\$36,606</i>	<i>\$38,057</i>	<i>\$40,988</i>	<i>\$48,280</i>
Global Macro	\$283	\$397	\$114	\$362	\$790	\$832
Long/Short Equity	2,154	3,067	6,232	3,931	2,861	3,353
Merger Arbitrage	116	143	189	71	102	119
Fixed Income Arbitrage	1,287	1,060	600	422	601	630
Convertible Arbitrage	164	434	483	109	142	134
Futures, Options	50	70	64	44	87	105
Sector	323	496	564	217	294	322
Distressed	711	1,613	2,342	1,304	1,577	2,057
Emerging Mkts	142	299	357	379	346	328
Multi-Strategy	4,236	5,320	7,514	5,361	4,378	5,174
<i>Hedge Funds</i>	<i>\$9,689</i>	<i>\$12,897</i>	<i>\$19,171</i>	<i>\$12,379</i>	<i>\$11,177</i>	<i>\$13,352</i>
Total	\$28,488	\$39,679	\$55,777	\$50,436	\$52,165	\$61,632

While the insurance industry’s private equity and hedge fund investments have both substantially increased since 2005, private equity has grown faster and now comprises 78% of the total, up from 66% in 2005. (Note: Fair value and actual cost in 2010 were \$62.3 and \$61.3 billion, respectively; not materially different from BACV.)

Unfunded Commitments

One aspect almost unique to private equity investing is unfunded commitment, or “overhang” liability. When investors subscribe to a private equity fund, their commitment is typically not fully or immediately paid-in; instead, capital is “called” or “drawn-down” over time as investment opportunities arise. Upon becoming a limited partner (or equivalent), such funding commitments are enforceable contractual obligations of the insurer. Subject to the terms of the agreement, such draw-downs generally are not within the insurer’s discretion.

In 2010, insurers’ private equity and hedge funds had unfunded commitments totaling \$21.5 billion: \$12.3 billion was with respect to leveraged buyout funds, with the rest split between venture capital (\$4.3 billion) and mezzanine (\$4.4 billion) funds, with hedge funds accounting for a relatively small \$471 million. If fully drawn, the \$21.0 billion overhang in private equity funding would increase the industry’s exposure in that group by 43%, from \$48.2 to \$69.2 billion.

Risk and Return

Table 3 shows the year-to-year change in fair value, inclusive of contributions, distributions, other than temporary impairments (OTTI) and other adjustments. (It was not feasible to separate these components consistently, given revisions to Schedule BA in 2008). It comes as no surprise that 2008 was not a good year. Year-to-year changes in BACV (not shown) are nearly the same as for fair value, although merger arbitrage and emerging markets strategies performed worse on a fair value basis, whereas multi-strategy fared better.

Changes in Fair Value	2006-06	2006-07	2007-08	2008-09	2009-10	2010-2010
Venture Capital	\$1,998	\$3,217	(\$423)	(\$380)	\$1,655	\$5,262
Mezzanino	1,696	934	2,791	613	190	6,247
Leveraged Buyout	4,257	3,539	(495)	2,095	3,396	16,539
<i>Private Equity</i>	\$7,954	\$9,679	\$1,755	\$2,337	\$7,601	\$29,347
Global Macro	\$114	\$17	\$145	\$234	\$38	\$519
Long Short Equity	955	3,199	(\$2,272)	(\$1,067)	463	1,260
Merger Arbitrage	27	47	(119)	32	17	3
Fixed Income Arbitrage	(206)	(194)	(464)	181	227	(457)
Convertible Arbitrage	290	(31)	(293)	33	(7)	(309)
Future, Options	21	16	130	43	18	55
Sector	(11)	57	(362)	97	6	(204)
Distressed	868	743	(\$1,041)	310	467	1,347
Emerging Mkts	117	296	(179)	(33)	(94)	110
Multi-Strategy	1,693	2,168	(\$1,155)	(987)	1,241	1,383
<i>Hedge Funds</i>	\$3,227	\$6,277	(\$6,748)	(\$1,159)	\$2,396	\$3,995
Total	\$11,182	\$16,957	(\$4,993)	\$1,199	\$9,997	\$33,341

As shown in Table 4 below, investment income of \$2.9 billion in 2010 had not yet recovered to the 2007 level of \$4.5 billion level. Investment income among the previously mentioned funds not designated as a hedge or private equity totaled \$933 million in 2010.

Table 4: Reported investment income by year (\$millions)

Investment Income	2005	2006	2007	2008	2009	2010	2006-2010
Venture Capital	\$314	\$307	\$799	\$423	\$192	\$463	\$2,497
Mezzanine	381	451	549	317	100	636	2,514
Leveraged Buyout	1,497	2,129	2,863	896	452	1,502	9,378
Private Equity	\$2,192	\$2,886	\$4,172	\$1,606	\$825	\$2,661	\$14,342
Global Macro	\$0	\$1	\$1	\$0	\$11	\$16	\$30
Long/Short Equity	15	10	42	121	110	14	329
Merger Arbitrage	0	0	0	0	0	0	0
Fixed Income Arbitrage	1	4	5	16	(7)	6	25
Convertible Arbitrage	(1)	0	0	8	0	1	9
Futures, Options	10	7	0	0	0	0	17
Sector	4	9	3	1	30	0	50
Distressed	74	100	147	4	75	30	437
Emerging Mkts	4	1	0	5	75	30	113
Multi-Strategy	120	120	156	78	105	126	722
Hedge Funds	\$234	\$278	\$353	\$234	\$410	\$220	\$1,730
Totals	\$2,427	\$3,164	\$4,925	\$1,548	\$1,230	\$2,891	\$16,872

Insurers as Providers of Investment Capital

In addition to private equity and hedge funds not being material to insurers' overall assets, neither is the U.S. insurance sector a material "capital provider" to such funds. The insurers' \$61.6 billion investment is compared with estimates of total private equity and hedge funds' capital of approximately \$4 trillion.

Why Do Insurers Invest in Private Equity and Hedge Funds?

Insurers invest in private equity and hedge funds for the same reasons as other institutional investors: to obtain higher returns, to increase diversification (thereby reducing risk), and to access additional or emerging asset classes. These investments fit within an overall framework of asset-liability management that balances risk and return, while providing for the overall liquidity needs of the insurer. The long-term nature of insurers' liabilities, especially compared to those of banks and broker-dealers, lends itself ideally to longer-dated or illiquid investments such as private equity and hedge funds. Detailed reporting and valuation guidelines provide state insurance regulators the necessary tools to examine these investments for appropriateness at a given insurer. At the same time, recognizing the risks inherent in these investments, hedge funds and private equity funds also carry the highest risk-based capital factor for investments.

April 16, 2012								
Major Insurer Share Prices			Change %			Prior		
		Close	Week	QTD	YTD	Week	Quarter	Year
Life	Aflac	\$42.81	(2.0)	(1.0)	(1.0)	\$43.68	\$43.26	\$43.26
	Ameriprise	53.61	(1.8)	8.0	8.0	54.58	49.64	49.64
	Genworth	7.62	(0.8)	16.3	16.3	7.68	6.55	6.55
	Lincoln	24.17	(1.4)	24.5	24.5	24.51	19.42	19.42
	MetLife	35.49	(0.9)	13.8	13.8	35.80	31.18	31.18
	Principal	27.83	(1.6)	13.1	13.1	28.29	24.60	24.60
	Protective	28.35	(0.3)	25.7	25.7	28.43	22.56	22.56
	Prudential	60.05	(1.9)	19.8	19.8	61.23	50.12	50.12
	UNUM	23.55	0.2	11.8	11.8	23.51	21.07	21.07
PC	ACE	\$72.48	0.2	3.4	3.4	\$72.34	\$70.12	\$70.12
	Axis Capital	33.51	0.0	4.8	4.8	33.51	31.96	31.96
	Allstate	32.47	0.1	18.5	18.5	32.43	27.41	27.41
	Arch Capital	37.90	1.3	1.8	1.8	37.43	37.23	37.23
	Cincinnati	34.26	1.7	12.5	12.5	33.68	30.46	30.46
	Chubb	71.05	2.2	2.6	2.6	69.55	69.22	69.22
	Everest Re	93.13	0.2	10.8	10.8	92.99	84.09	84.09
	Progressive	22.61	(1.2)	15.9	15.9	22.89	19.51	19.51
	Travelers	59.16	1.6	(0.0)	(0.0)	58.23	59.17	59.17
	WR Berkley	36.91	1.8	7.3	7.3	36.24	34.39	34.39
	XL	21.21	(0.6)	7.3	7.3	21.33	19.77	19.77
Other	AON	\$48.53	0.9	3.7	3.7	\$48.08	\$46.80	\$46.80
	AIG	32.80	2.5	41.4	41.4	31.99	23.20	23.20
	Assurant	38.94	0.4	(5.2)	(5.2)	38.79	41.06	41.06
	Fidelity National	18.53	2.8	16.3	16.3	18.02	15.93	15.93
	Hartford	20.09	(1.7)	23.6	23.6	20.44	16.25	16.25
	Marsh	32.21	0.9	1.9	1.9	31.91	31.62	31.62
Health	Aetna	\$47.22	(3.2)	11.9	11.9	\$48.80	\$42.19	\$42.19
	Cigna	47.69	(0.6)	13.5	13.5	47.99	42.00	42.00
	Humana	87.48	(2.1)	(0.1)	(0.1)	89.39	87.61	87.61
	United	57.36	(1.5)	13.2	13.2	58.23	50.68	50.68
	WellPoint	68.74	(2.7)	3.8	3.8	70.64	66.25	66.25
Monoline	Assured	\$14.77	(2.6)	12.4	12.4	\$15.17	\$13.14	\$13.14
	MBIA	10.09	7.3	(12.9)	(12.9)	9.40	11.59	11.59
	MGIC	4.16	(7.3)	11.5	11.5	4.49	3.73	3.73
	Radian	3.45	(5.7)	47.4	47.4	3.66	2.34	2.34
	XL Capital	21.21	(0.6)	7.3	7.3	21.33	19.77	19.77

April 16, 2012									
Major Market Variables		Close	Change %			Prior			
			Week	QTD	YTD	Week	Quarter	Year	
Dow Jones Ind		12,921.41	(0.1)	5.8	5.8	12,929.59	12,217.56	12,217.56	
S&P 500		1,369.57	(0.9)	8.9	8.9	1,382.20	1,257.60	1,257.60	
S&P Financial		205.23	(0.3)	17.1	17.1	205.81	175.23	175.23	
S&P Insurance		184.16	0.0	8.2	8.2	184.10	170.17	170.17	
US Dollar \$			Change %			Prior			
/ Euro			\$1.31	0.2	1.4	1.4	\$1.31	\$1.30	\$1.30
/ Crude Oil bbl			103.06	0.7	4.3	4.3	102.36	98.83	98.83
/ Gold oz			1,648.70	0.4	5.2	5.2	1,642.50	1,566.80	1,566.80

April 16, 2012				Weekly Change				
Major Insurer Bond Yields				Price			Spread	
				Current	Change	Yield	B.P.	Change
Company	Coupon	Maturity						
Life	Aflac	8.500%	5/15/2019	\$131.93	(\$0.03)	3.38%	190	2
	Ameriprise	5.300%	3/15/2020	\$111.70	\$0.38	3.59%	197	3
	Genworth	6.515%	5/15/2018	\$103.47	(\$0.20)	5.83%	466	9
	Lincoln National	8.750%	7/15/2019	\$127.99	\$0.39	4.20%	272	0
	MassMutual	8.875%	6/15/2039	\$144.22	\$0.15	5.66%	259	3
	MetLife	4.750%	2/15/2021	\$109.55	(\$0.65)	3.48%	164	13
	Mutual of Omaha	6.800%	6/15/2036	\$109.50	(\$0.11)	6.05%	317	5
	New York Life	6.750%	11/15/2039	\$129.83	\$1.11	4.79%	175	1
	Northwestern Mutual	6.063%	3/15/2040	\$120.92	\$0.42	4.71%	162	3
	Pacific Life	9.250%	6/15/2039	\$129.05	(\$0.52)	6.87%	383	9
	Principal	6.050%	10/15/2036	\$110.44	\$1.92	5.28%	238	(5)
	Prudential	4.500%	11/15/2020	\$106.73	(\$0.44)	3.58%	179	10
	TIAA	6.850%	12/15/2039	\$126.75	\$0.33	5.04%	196	2
P&C	ACE INA	5.900%	6/15/2019	\$121.24	\$0.01	2.62%	113	3
	Allstate	7.450%	5/15/2019	\$127.00	\$0.26	3.16%	173	0
	American Financial	9.875%	6/15/2019	\$126.36	\$0.36	5.38%	388	(1)
	Berkshire Hathaway	5.400%	5/15/2018	\$118.71	\$0.19	2.10%	89	2
	Travelers	3.900%	11/15/2020	\$109.13	\$0.05	2.69%	93	4
	XL Group	6.250%	5/15/2027	\$104.92	(\$0.00)	5.76%	336	3
Other	AON	5.000%	9/15/2020	\$111.20	\$0.01	3.46%	170	4
	AIG	5.850%	1/15/2018	\$109.24	(\$0.11)	4.03%	291	3
	Fidelity National	7.975%	7/15/2020	\$111.38	\$0.44	6.10%	450	(14)
	Hartford	5.500%	3/15/2020	\$105.35	(\$0.34)	4.69%	301	11
	Marsh	9.250%	4/15/2019	\$133.65	\$0.03	3.73%	227	5
	Nationwide	9.375%	8/15/2039	\$127.96	\$0.57	7.05%	399	0
Health	Aetna	3.950%	9/15/2020	\$106.96	\$0.18	3.00%	129	5
	CIGNA	5.125%	6/15/2020	\$111.32	(\$0.11)	3.52%	186	9
	United Healthcare	3.875%	10/15/2020	\$107.63	\$0.55	2.86%	115	(1)
	Wellpoint	4.350%	8/15/2020	\$110.39	\$0.27	2.93%	122	(0)

Questions and comments are always welcomed. Please contact Ed Toy, (212) 386-1974, etoy@naic.org

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