Beware of Private Equity Gobbling Up Life Insurance and Annuity Companies

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Overview

Private equity (PE) firms have had their eye on individual retirement savings since 2013 when they were first allowed to market directly to individuals. Pension funds already allocate workers' retirement savings to PE firms, which use these assets to fund a range of risky equity and debt investments. Access to personal retirement savings, including IRAs and 401(k)s, would open up a huge new source of capital for PE.

PE firms' first attempts to get a piece of these very sizable direct contribution assets were largely unsuccessful. More recently, however, they have turned to acquiring and/or managing life insurance and annuity assets. Some PE firms buy out life insurance and annuity companies, acquiring their assets. Others take a minority stake in a life insurance or annuity company in exchange for the right to manage all of the company's assets. In both cases, the PE firm substantially increases assets under its management. They have also stepped-up efforts to recruit near-wealthy as well as wealthy investors, so-called retail investors, to allow PE firms to manage their assets. These activities have been a game changer for the largest PE firms. As Blackstone CEO Stephen Schwarzman put it as he lauded the firm's third quarter 2021 performance, this quarter has been "the most consequential quarter [in history] . . . a defining moment in terms of our expansion into the vast retail and insurance markets."[1]

Meanwhile, policyholders find that a PE firm now manages their retirement savings. This raises a major concern for individuals and government regulators: Given PE firms' track record of failing to observe their duty of care as owners of Main Street companies as well as their poor fund performance in recent years,[2] can they be trusted to protect the retirement savings of millions of Americans?

Moreover, private equity firms have already begun using insurance assets to invest in high fee alternative investments, including the PE firms' own buyout, real estate, and debt funds. These activities raise the question whether, in the current absence of regulatory oversight, PE firms are engaged in self-dealing or have significant conflicts of interest. These possibilities are very real as PE firms can use these insurance assets to bolster the performance of their

1 Jacobius. *Firms Eye the Prize: Wooing and Winning Retail Investors*
2 Ayash and Rastadz, *Leveraged buyouts and financial distress;* Appelbaum and Batt, *The Routledge Companion to Management Buyouts*, 248-277; Phalippou, *An Inconvenient Fact: Private Equity Returns & The Billionaire Factory*

own struggling funds. Even in the absence of patently illegal actions, PE control of life insurance assets raises basic conflict of interest questions: Are PE firms looking out for the interests of insurance beneficiaries, or are they more concerned with making exorbitant profits for themselves and their investors?

PE firms find insurance assets attractive because they provide them with a form of "permanent capital." Typically, PE firms raise capital by recruiting investors and launching an investment fund with a life span of 10 years, after which time they pay out all of the capital in the fund and liquidate it. PE firms launch these funds every few years. By contrast, individual retirement savings are permanent capital in the sense that they do not need to be paid out at the end of 10 years and don't require the PE firm to recruit investors every couple of years.

For the people who own these life insurance and annuity policies, a danger exists that PE investments in risky assets may not provide them with the peace of mind and the assurance that the benefits will be there when they are needed. While life insurance companies are for-profit businesses, they have historically invested in publicly traded stocks and high-grade corporate bonds that can be easily sold if the insurance company needs cash. However, private equity-owned insurance companies seek higher relative yield by investing in riskier assets, such as private debt and equity. These assets pay higher rates of interest than the plain vanilla bonds and stocks of publicly traded companies. But they are illiquid, meaning that they are difficult to sell if cash is suddenly required to satisfy a spike in demand for payouts, like a recession, when policyholders may want to exercise provisions in their policies that allow them to access funds in their retirement savings accounts.

Moreover, the claim that investing life insurance assets in risky alternative strategies increases benefits for policyholders may fail, either because of the very real possibility that the investment fails or because the high fees charged for managing complex investments eat up the higher performance associated with greater risk. For consumers who bought life insurance and annuity policies from stodgy insurance companies making plain vanilla investments, it may be disconcerting to learn that their policy has been sold to a PE firm that will be making risky investments with a portion (currently thought to be 5 to 10 percent of assets) of their retirement savings. The biggest risk, in this case, is that annuity payments will be below what beneficiaries were led to expect.

Given these new developments, new regulations are clearly needed to protect the retirement savings of holders of life insurance and annuity policies. The opaqueness of PE, and the lack of transparency regarding its activities, makes regulation difficult. Federal regulation to cap the fees that policyholders pay are needed. And policies to assure that insurance companies whose assets are owned or managed by PE firms hold adequate reserves against their risky investments is vital. Some PE firms have already moved the headquarters of insurance companies they own to Bermuda, presumably because of lax regulation in that country. This issue did not arise in the past because publicly traded life insurance companies invested conservatively. Still, headquartering an insurance company in a country with lax regulations does not allow them to escape requirements put in place by state insurance regulators in the states where they do business. State insurance regulators have a key role to play.

The danger is that PE-owned insurers will manage to fall between the regulatory cracks, with state regulators relying on federal agencies to regulate the companies while federal agencies defer to state insurance regulators. Regulation of insurance at the state level already varies from lax to strict across the 50 states where an insurance company does business.

What follows is an examination of the size of retirement savings in the US; a brief review of earlier, largely unsuccessful attempts by PE firms to gain access to the savings of individuals; and, a discussion of PE's foray into life insurance and annuities in recent years. Private equity's control of life insurance assets has greatly increased, with little to no regulatory oversight or protections for beneficiaries.

US Retirement Assets

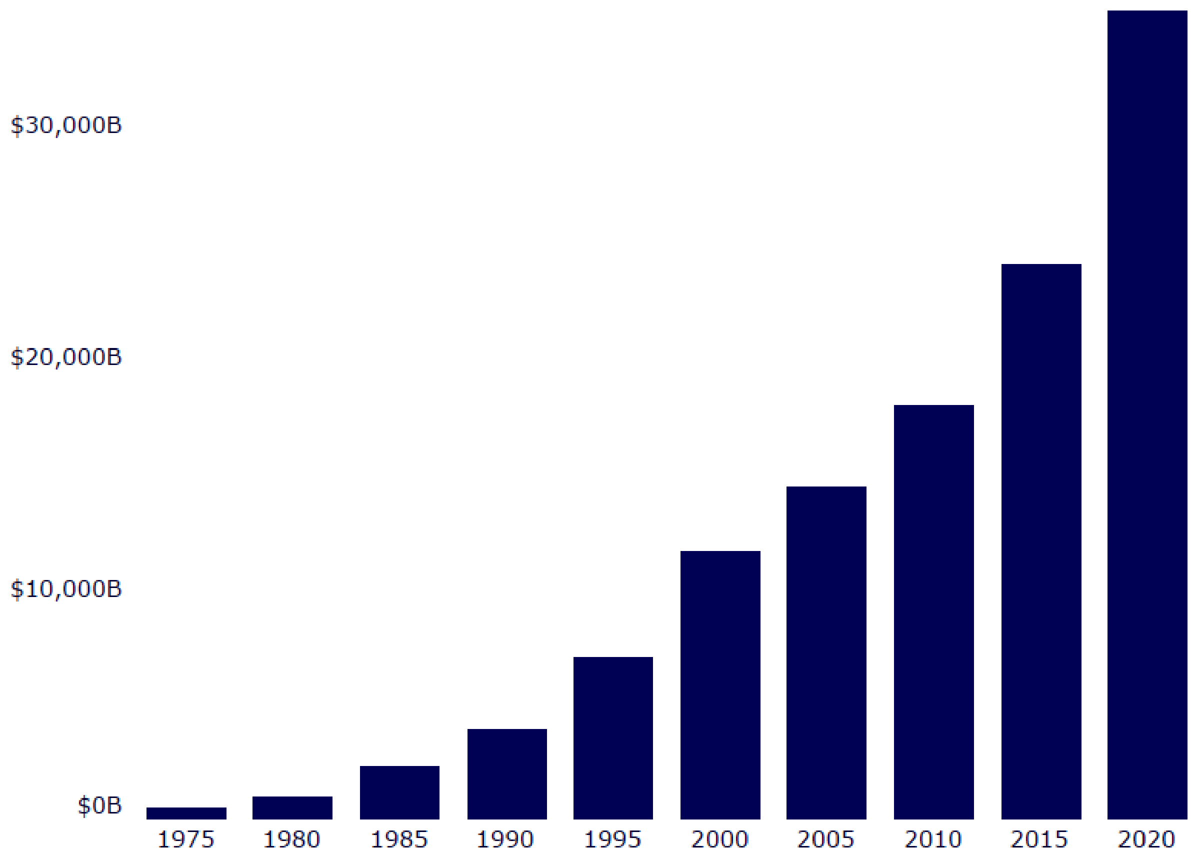
US retirement savings have exploded in the last 30 years, reaching $35 trillion in 2020, nine times as much as in 1990. Pensions (direct benefit plans) have declined as a share of retirement savings, most dramatically in the public sector. Direct contribution plans (IRAs and 401(k)s) have grown in volume and importance. IRAs have seen the most dramatic growth, but 401(k) plans account for a large share of retirement assets (see figures below).[3]

3 SEI Investment Manager Services, *Evolving Forces: Convergence in the U.S. Retirement Market Place*

Figure 1

Total U.S. Retirement Assets

Billions, 1975—2020

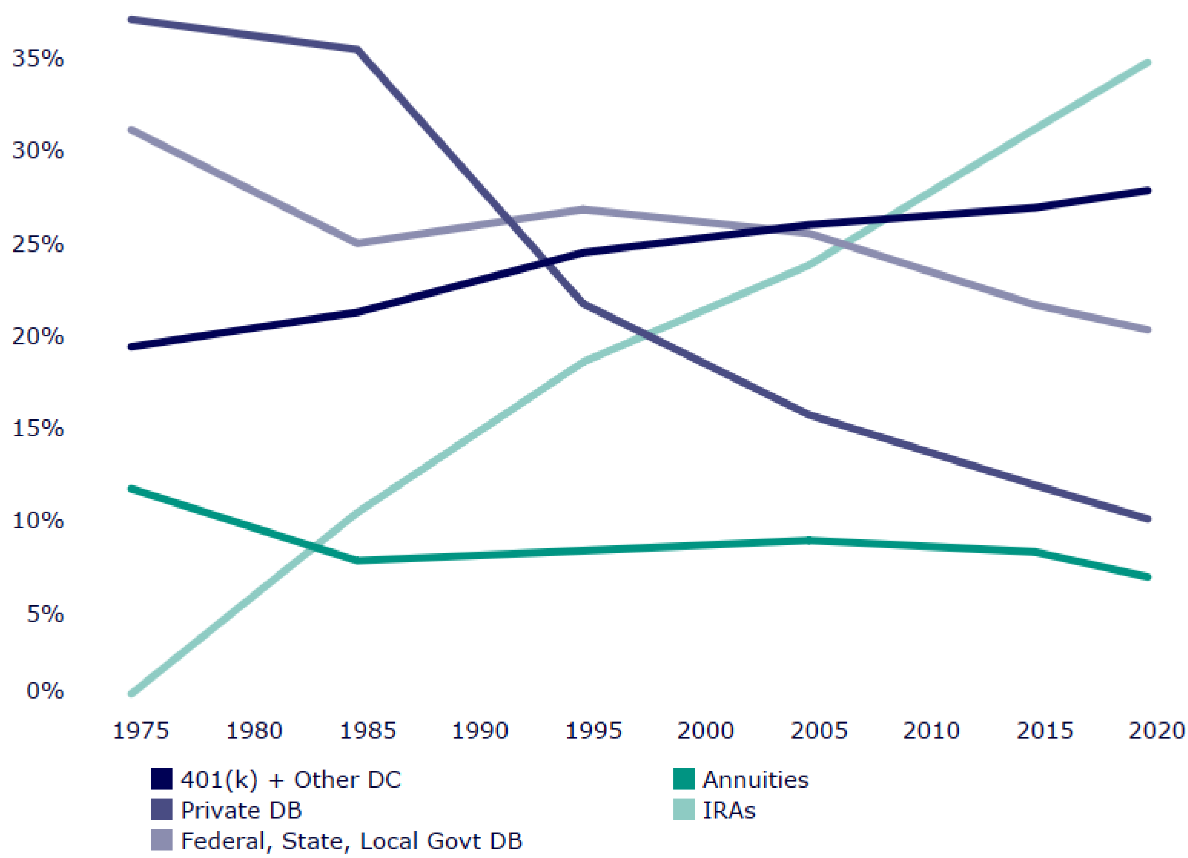


Source: Investment Company Institute

Figure 2

Historical Share of U.S. Retirement Market by Plan Type

Percent of Market Share, 1975—2020



Source and Notes: Author's analysis of Current Population Survey data from the US Bureau of Labor Statistics.

Private Equity Tries (Unsuccessfully) to Tap Individual Retirement Savings

Workers' pension funds have provided at least one-third of the equity contributions to PE investment funds over the past two decades. Public pension funds' share of retirement savings has been declining over the last decade and longer. To compensate for this decline, PE firms have had their eye on workers' individual retirement nest eggs—401(k) and IRA accounts—since late 2013, when rules on advertising to individuals were relaxed. But PE firms have had only limited success tapping into IRA and 401(k) accounts. They were stymied by the Obama Labor Department, which held the line against letting risky PE and hedge fund products into workers' individual retirement accounts.[4] PE had some success during the Trump administration as the Labor Department issued an Information Letter in June 2020 that allowed some PE products into these accounts.[5] Some brokers misinterpreted the Information Letter as endorsing or recommending inclusion of these products in workers' accounts. But others were slow to include them because they lacked the experience and the confidence to recommend them and because of the high fees attached to these products. They were concerned that poor performance of these assets could expose them to litigation and liability claims. Similar concerns were raised by consumer advocates. In response, Biden's Labor Department issued a Supplemental Statement in December 2021 that clarified the use of PE products in defined contribution plans. It cautioned brokers, as retirement plan fiduciaries, against including these products if they lacked the expertise to determine the prudence of doing so.[6]

By contrast, PE firms have long included very wealthy individuals among the investors in their funds. But since 2015, they have tried to develop new products for the near-wealthy.[7] These efforts continue today, with much promise for "brand name" PE firms, though success is still limited.[8] Most of these "retail" investors are effectively excluded from PE and hedge fund investments. The Trump administration's Securities and Exchange Commission (SEC) chair, Jay Clayton, pushed to open these funds to more investors. In September 2021, an SEC panel formed in 2019, the Asset Management Advisory Committee, recommended letting ordinary investors into these funds.[9] But current SEC chair Gary Gensler's remarks have indicated that the agency will take a tougher stance for greater transparency on fees and expenses and against conflicts of interest. These SEC actions may undermine PE's efforts to attract money from retail investors.[10]

4 Appelbaum. *As Public Pensions Shift from Hedge Funds, Hedge Funds Look to Main Street*
5 Appelbaum. *CEPR Statement on New Labor Department Guidance Allowing Risky Private Equity Investments in Workers' 401(k) Accounts*
6 Correia, "*Labor Department Warns about Private Equity in DC Plans.*"; "*US Department of Labor releases Supplemental Statement on private equity investments in participant-directed retirement savings plans.*"
7 Appelbaum, "*Private Equity Is Going Retail.*"
8 Jacobius, "*Firms Eye the Prize: Wooing and Winning Retail Investors.*"
9 Cumming, "*SEC Panel Backs Letting Ordinary Investors into Private Equity.*"
10 Davies, "*Gary Gensler's Everything Crackdown Reaches Private Equity.*"

Private Equity Is Eating Up Life Insurance and Annuities Companies

Given the obstacles to attracting retail investors, PE funds have turned to buying up life insurance and annuity companies as an alternative route to tapping into the retirement savings of millions of Americans. Recruiting limited partner (LP) investors for the funds that PE firms raise every few years has become increasingly burdensome. Tapping into retirement savings creates a source of "permanent capital" as savings flow into retirement assets, creating a pool of assets that can fund PE investment activities. Despite the lack of success in penetrating workers' IRAs and 401(k)s, retirement savings remain an enticing source of capital for PE funds.

In their efforts to buy out insurance and annuity companies, PE firms are taking a leaf out of Warren Buffet's playbook. For decades Buffett has funded investments in publicly traded companies from his $360 billion insurance arm.[11] Accumulated life insurance and retirement assets and ongoing premium payments for annuities and death benefits are an attractive, permanent source of investment capital.

Some PE firms are buying up entire life insurance companies and annuity businesses. Others are taking a minority stake in them and then managing all of the insurance assets. Only the largest PE firms have the financial wherewithal to afford deals to manage or own the life insurance and annuity businesses of major old-line insurance companies. But even smaller PE firms have gotten into the game, buying up smaller life insurance businesses and selling indexed annuities, a line of business they view as an extension of their investment experience.

In just a few years, insurance assets have become a major component of assets under the management of PE firms. At the end of 2020, aggregate holdings of cash and invested assets of US life insurance companies were $4.9 trillion. PE firms controlled 9.6 percent of these assets—a total of $471 billion. Of the slightly more than 400 US life insurance companies, 50

11 Davies, "*Apollo Wants to Be a Bit like Buffett, But It's Complicated.*"

are owned or controlled by more than 24 PE firms. These include well-known PE firms such as Blackstone, Apollo, and KKR; but also, many little known PE firms.[12]

Recruiting retail investors remains on PE's wish list, and efforts are underway to provide attractive products for this valuable group of investors—another source of permanent capital for successful firms. Apollo, for example, projects that retail capital will represent roughly 30 percent of its annual fundraising in 2026, compared to only 5 percent in 2018–2020.[13]

With respect to engagement with the life insurance and annuities market, Apollo is probably the most advanced. It has had a stake in the life insurance company Athene since 2015. In 2021, it acquired the entire company and now owns Athene's insurance assets worth about $194 billion. Apollo says it plans to invest about 5 percent of Athene's funds in riskier, fee-paying alternative assets, including it s own PE and debt funds.[14] This kind of self-dealing is rife with potential conflicts of interest. Will Apollo's insurance unit look out for its beneficiaries or its investors and shareholders?

Unlike Apollo, Blackstone prefers to gain minority stakes in life insurance companies, take over management, and control of most or all of their assets. It invests them in alternative strategies in search of higher yields. In 2021, Blackstone paid $2.2 billion to American International Group (AIG) for a 9.9 percent stake in its life insurance and annuities unit. Initially, Blackstone will manage $50 billion of AIG's life insurance assets. In the coming years, this is scheduled to rise to nearly $100 billion. Blackstone also struck a deal in 2021 to buy a life insurance unit of Allstate Corporation. With these transactions, Blackstone's insurance assets under management will reach $150 billion by the end of 2021. The insurance assets it controls account for a third of Blackstone's overall assets.[15]

In July 2020, KKR announced it was buying the life insurance and retirement income company Global Atlantic Financial Group for $4.4 billion and taking over management of about $70 billion of Global Atlantic's assets. The deal raised KKR's assets managed on behalf of insurance companies from about $26 billion to more than $96 billion. It increased KKR's total assets under management by 30 percent, from $207 billion to more than $277 billion. And it

12 Best, "*Private Equity Firms Keep Eating U.S. Life Insurers.*"
13 Jacobius "*Firms Eye the Prize: Wooing and Winning Retail Investors.*"
14 Davies, "*Apollo Wants to Be a Bit like Buffett, But It's Complicated.*"
15 Gottfried and Scism, "*Blackstone Enters Deal to Manage AIG Life and Retirement Assets.*"; Gara, "*Blackstone Braces for Higher Inflation as Earnings Hit Record.*"

increased the share of permanent capital—capital that does not need to be replenished by fundraising—from 9 percent to 33 percent. [16]

Dangers Facing Policyholders, Private Equity Conflicts of Interest, and the Need for Regulation

Regulating PE investments is challenging because little reliable public information exists about how these firms invest insurance assets, making it difficult to gauge risk and the effect on returns to beneficiaries. But clearly, they are moving some of the assets out of plain vanilla corporate bonds and equities and into private debt and asset-backed securities that expose policyholders to increased risk and provide PE firms with opportunities to earn high fees for managing the assets. Returns on private debt are usually higher than for the plain vanilla bonds, but investments in private debt are riskier. They are less transparent and more difficult to trade, making them difficult to sell to meet death benefit and annuity obligations, most pronounced in the case of an economic slowdown and cash crunch. This may endanger policyholders. The Federal Reserve has expressed concern that investments in difficult to sell debt and equity holdings may mean that insurers will lack cash to pay a surge of claims in an economic crisis. Not only do the assets lack liquidity, but they may also go down in value in these circumstances.[17]

It will be very complex for insurance regulators to monitor private equity's management of insurance assets. As a minimum protection for life insurance beneficiaries, insurance companies whose assets are owned or managed by PE firms need to hold higher reserves against these riskier investments. How the responsibility to protect insurance beneficiaries is divided between state insurance regulators and agencies of the federal government is not entirely clear. Beginning this year, insurers are required to file information about the credit ratings for the privately issued bonds and other private debt they purchase. Ratings companies have conflicts of interest as well as they are paid by the companies whose bonds

16 Gottfried and Sebastien, "*KKR to Buy Global Atlantic Financial Group for $4.4 Billion.*"
17 Scott, "*Chasing Yield, U.S. Private Equity Firms Nudge Up Risk on Insurers.*"

they rate. The ratings potentially understate the riskiness of the bonds. Federal insurance regulators are working through the National Association of Insurance Commissioners (NAIC) to set standards for state insurance regulators. The NAIC is working to determine whether this debt is riskier than the ratings indicate, meaning that insurers could experience unexpected losses. This affects the level of reserves insurers must hold to be able to pay insurance beneficiaries if the insurance company experiences losses on its riskier debt.[18]

Opportunities for corrupt self-dealing are widely available as PE firms can use the insurance assets to shore up the finances of failing or struggling funds they own. Such activities are difficult to detect as no requirements exist for public disclosure of transactions. Banning the practice of PE firms investing insurance assets they control in their own debt and buyout funds would prohibit this activity. At a minimum, rules to prevent corrupt self-dealing by PE firms need to be put in place. Recent statements by SEC Chair Gensler indicating that the SEC will act to increase transparency of PE's financial dealings are welcome in this context.

Caps on fees paid for investment in alternatives such as buyout or debt funds should be put in place so that fees paid to PE firms do not eat up higher earnings on these risky assets.

National standards for reserves against more risky investments for any company managing life insurance and retirement benefits in the US, regardless of where the company is headquartered, are needed to thwart moves to jurisdictions with lax reserve requirements.

In general, steps need to be taken to prevent the possibility that billionaire PE firm partners will further enrich themselves at the expense of holders of life insurance and annuity policies.

18 Scism, "*Regulators Seek Ratings Details for Privately Issued Bonds Held by Insurers.*"

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