LEGACY ASSET INVESTMENTS

MARCH 15, 2016

EXECUTIVE SUMMARY

On June 25, 2013 the Finance and Investment Committee requested Citizens' staff analyze and provide an investment recommendation on the Legacy Assets held in the portfolio. At that time, after analyzing the market conditions and security pricing, staff recommended continuing to hold the securities. Citizens has recovered an additional $82 million of principal based on that recommendation. The Legacy Assets are Structured Investment Vehicles ("SIV's") purchased on Citizens behalf by a former portfolio manager. The investments defaulted on their original obligation during the financial crisis in the Fall of 2007. Financial markets have recovered significantly since that time as U.S. economic conditions have improved. Throughout 2015 the market experienced stronger relative trading activity in SIV's as most of the old SIV's have partially matured and / or restructured. The State Board of Administration ("SBA") divested all of its LGIP Fund B assets invested in the same SIV's as Citizens during 2015 The purpose of Staff's investment recommendation is to highlight both the benefits and opportunity costs of divesting these assets.

BACKGROUND

Citizens currently holds five securities that make up the Legacy Assets: Lehman Brothers Holdings Escrow, AFF Financing, Atlantic East, Pacific West and Issuer Entity. The original principal amount of these combined holdings was $968.5 million prior to their default. Because these assets were determined to be distressed, $290.6 million in writedowns occurred on December 31, 2007, September 30, 2008, and December 31, 2008 in the amounts of $88.5 million, $117.8 million, and $84.3 million, respectively. All of the Legacy Assets, with the exception of Lehman, were restructured by October 2008 and resumed paying back both principal and interest on a monthly basis. Lehman emerged from bankruptcy to begin the full liquidation of all assets on March 6, 2012. Because the Legacy Assets were performing and providing above market returns, combined with the lack of liquidity for these securities, Citizens has continued to hold these assets. As of December 31, 2015 the principal payments received on the combined Legacy Assets since 2007 is in excess of $431 million, with $176 million still outstanding. The improving market conditions and continuing principal payments have allowed Citizens to recover almost $151 million of the original $237.5 million for a net writedown of $86.9 million, excluding Lehman Brothers Holdings Escrow. The current unrealized mark-to-market gain is approximately $39 million or 45% of the remaining unrecovered writedown.

Although the SIV's holdings have repaid a significant portion of the principal and interest payments since defaulting in 2007, the market value of remaining SIVs are expected to remain relatively unchanged as interest rates have less effect on the market price of these floating rate securities. Especially since the SIV's are asset backed securities where the great majority of the underlying collateral are residential mortgage investments. Most of these residential mortgage investments have been refinanced or otherwise paid off since 2007, which in turn lead to Citizens recovering large amounts of principal from the much improved housing market. Going forward staff does not expect to continue to see large amounts of refinancing as homeowners that could refinance did so during the historically low interest rate environment of the last few years. Underlying mortgage securities not refinanced could have a 30 year holding period until final maturity from issuance in 2006. Citizens has the option to liquidate its SIV legacy assets and reinvest in liquid securities pursuant to its new investment policy to maximize investment returns. Liquidating these securities will also limit future market risk and volatility and will also bring the overall portfolio into compliance with the new investment policy.

Citizens monitors and values the SIV's by having the custodian bank price all the underlying bonds in the pool of securities to determine a market or fair value. Market prices may be at discount from what staff considers a fair market price due to different pricing techniques, market volatility, and higher trading spreads. The market sale price of the SIV portfolio is expected to be approximately 85% ± 5% (80% - 90%) of its current market value of $129 million, or in the range of $103-$116 million. The discount of 15% ± 5% is primarily due to market volatility and higher trading spreads in the underlying securities within the SIV's. The sale of the SIV portfolio will allow Citizens to realize mark-to-market gains of approximately $14-$26 million based on a preliminary sale price at 85% ± 5%, which will increase net income dollar for dollar. In addition to the contribution of surplus through realized gains of $14-$26 million, Citizens would reverse a charge to surplus for non-admitted assets of $39 million as a result of accounting treatment prescribed by F.S. 625.305 following disposition, thereby increasing total surplus by $53-$65 million in sum.

RECOMMENDATION

Citizens' staff worked closely with its Financial Advisor on the economic analysis of the Legacy Assets. Staff also consulted with the Apollo Group who manages the underlying securities in the four structured investment vehicles "SIV's" (AFF, ATL East, PAC West and Issuer). Lehman Brothers Holdings Escrow are excluded from staff's recommendation as Lehman Brothers is winding down the liquidation of its assets from the bankruptcy proceedings.

Staff recommends that the Board authorize Citizens' staff to work with its Financial Advisor to develop a strategy to sell its SIV legacy securities in the price range of at least 85% ± 5% of the current market value of $129 million to generate sale proceeds of $103-$116 million.