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A.M. Best's Rating Outlook Remains Stable On Life & Annuity Sector

Deteriorating Capital Could Influence a Change in Opinion on the Rating Outlook

A.M. Best Co.'s rating outlook on the U.S. life insurance and annuity sector remains stable through midyear 2012, despite the continued pressure of the low interest rate environment on earnings. The Federal Reserve has indicated that interest rates will remain at historically low levels through at least midyear 2015, based on the most recent Federal Open Market Committee statement on Sept. 13, 2012. Life and annuity writers are at particular risk due to their dependency on investment income to supplement underwriting income and ultimately generate profitable earnings trends for stakeholders and policyholders.

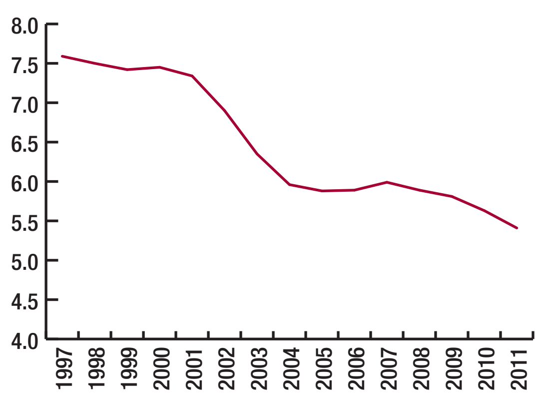
Asset-liability matching (ALM) is critical for insurers in order to match their long-duration liabilities, particularly interest-sensitive business – such as fixed and variable annuities (VAs), universal life with secondary guarantees, preneed products, long-term disability and long-term care (LTC) – with assets which will generate positive spreads, minimize reinvestment risk and achieve their investment income targets.

Insurers have historically preferred the fixed-income securities (FIS) asset class – U.S. government, foreign government, U.S. state and special revenue (municipals), utilities, corporate and asset-backed securities – due to their generally fixed returns and high-credit quality. Since a large percentage of an insurance company's investment portfolio typically consists of FIS that were purchased at higher yields than currently are available, portfolio yields are likely to decline unless insurers reinvest in higher risk securities. In the decades prior to the financial crisis, FIS offered attractive yields that allowed companies to match their assets with long-duration liabilities, with few concerns regarding minimum interest guarantees. However, from 1997 to 2011, net yields for FIS have been declining fairly consistently, which has increased the challenge to manage investment portfolios (see **Exhibit 1**).

To counteract the impact of low interest rates on spread compression and earnings volatility, insurers are strategically de-risking their legacy product portfolios. Strategies include exiting, repricing or de-emphasizing certain business lines, particularly interest-sensitive businesses, and in some cases, revising their investment allocations to stretch for yield. However, other companies, instead, have de-risked their investment portfolios, which may accelerate investment yield deterioration.

Exhibit 1

U.S. Life/Health – Historical Net Yield on Fixed Income Securities (1997-2011)



Source: BestLink – Best's Statement File, L/H, US

De-risking Initiatives

Insurers that offered rich product guarantees prior to the recent market downturn are now paying a heavy price. Market

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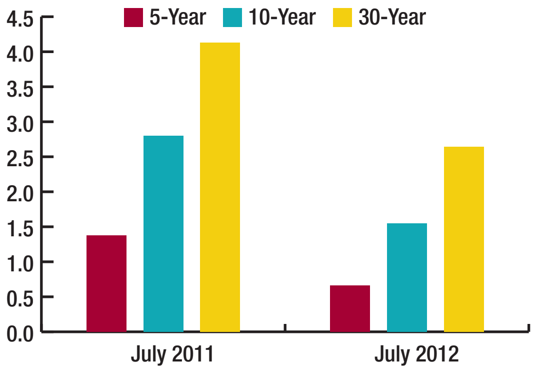
Exhibit 2
U.S. Life/Health – Treasury Yields



Source: Federal Reserve System

conditions are resulting in earnings pressures from both spread compression and reserve strengthening, which have prompted strategic decisions to scale back on product sales and reduce guaranteed benefits, crediting rates and bonus rates. Companies that do not have diversification in their sources of earnings/reserves may face more drastic ramifications, including rating pressure, if they cannot successfully execute de-risking initiatives.

Examples of recent de-risking initiatives include Aegon USA Group's reduction in hedge fund holdings in favor of an increased exposure to Treasurys and other short-term investments. The company also placed its institutional spread-based business in run-off allowing for a more balanced mix of business between spread and fee-based products. In another example, following the appointment of a new chief investment officer, Aflac recently began implementing a new investment strategy, which included a fairly comprehensive investment portfolio de-risking initiative. Additionally, in an effort to mitigate longer-term exposure, Hartford Financial Services Group, AXA Insurance S.A. and Aegon N.V.'s Transamerica are offering lump-sum payments to contract holders who surrender VAs with particularly rich living benefit guarantees. Prior to the financial crisis, when 10-year Treasury securities offered attractive rates, these contracts offered generous benefits, which are now stressing insurers' balance sheets and increasing longer-term uncertainty. Given the extended duration of the low interest rate environment, A.M. Best anticipates that more companies may attempt to buy out certain of their guaranteed commitments, rather than face continued longer-term uncertainty.

In other instances, companies are exiting or de-emphasizing certain individual life and annuity product lines. For instance, Hartford Financial Services announced in early 2012 that it was exiting the life insurance business and will concentrate the allocation of capital to businesses that take insurance risk (property and casualty) and reduce the allocation to businesses that take market risk. Sun Life Financial also announced this year that it is exiting the U.S. individual life and annuity markets. John Hancock Life Insurance Co., a subsidiary of Manulife Financial, has discontinued a variety of VA and market-value adjusted and immediate annuity products, citing concerns over the volatile equity markets and historically low interest rate environment.

LTC insurance is another segment negatively affected by low interest rates. Prudential Financial's recent decision to exit the group LTC market subsequent to announcing its exit from the individual LTC market in March 2012 is another example of companies re-evaluating their business strategies. The company's decision was based on the impact of the continued low interest rate environment and its desire to achieve appropriate returns, enhance its long-term risk profile and further its longer-term goal of sustainable, profitable growth in its core group life and disability lines of business.

Unum Group announced earlier this year that it also will no longer be selling group LTC, after having discontinued sales of individual LTC in 2009. Also, Berkshire Life

Insurance Company of America, a unit of Guardian Life Insurance Company of America, halted sales of its LTC product effective year-end 2011. MetLife Inc. exited the individual LTC market in late 2010, and Allianz Life Insurance Company of America decided to stop selling standalone LTC products in late 2009.

Stretch for Yield

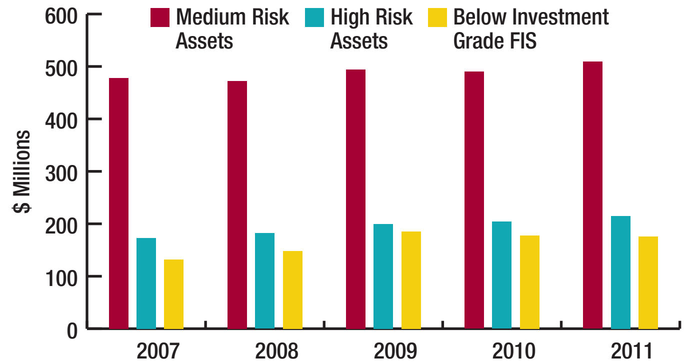
A.M. Best has observed that many organizations have refined their investment allocations to protect against the prolonged low interest rate environment. Some insurers have used the recent stability in more distressed asset classes to pare their positions while others have moved down the credit scale or lengthened duration in an effort to generate yield despite a relatively flat yield curve. Others have increased allocations to commercial mortgage loans to capture incremental yield over comparable bonds of similar duration. However, long-term bonds continue to generate the lion's share of total investment income.

Some companies have been deploying cash and short-term instruments into lower-quality, higher-risk investments, in essence stretching their investment guidelines in an effort to generate yield. As illustrated in **Exhibits 3, 4,** and **5**, medium and high risk assets, including equities and mortgage loans, have become more attractive and are being targeted by investment teams.

However, stretching for yield has its drawbacks, particularly as it relates to the calculation of risk-adjusted capitalization. Best's Capital Adequacy Ratio (BCAR), A.M. Best's proprietary risk-adjusted capital model, carries more punitive C-1 (Asset Risk) charges as investments enter higher risk classes (NAIC classes 3-5: mortgages, equities, and alternative investments); hence, requiring a higher level of absolute capital to maintain ratios consistent with an insurer's current ratings. The NAIC's plans to revisit its C-1 factors for its RBC model could increase the potential for higher C-1 charges in A.M. Best's capital model. Therefore, the stretch for yield without maintaining higher levels of absolute capital could put pressure on ratings.

Exhibit 3

U.S. Life/Health – Asset Risks* (2007-2011)

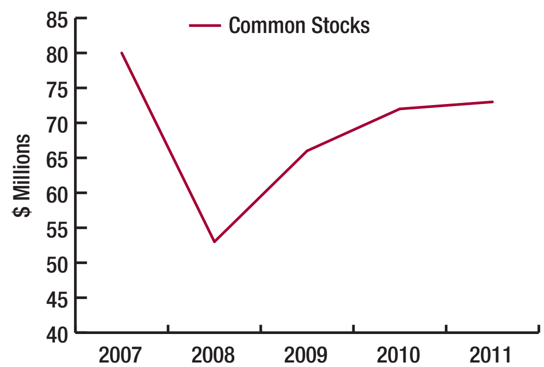


*A.M. Best defines medium risk assets as NAIC Class 3 FIS, common equities and mortgage loans. High risk assets are defined as NAIC Class 4 and 5 FIS, direct investments in real estate and derivatives.

Source: BestLink® – Best's Statement File, L/H, US

Exhibit 4

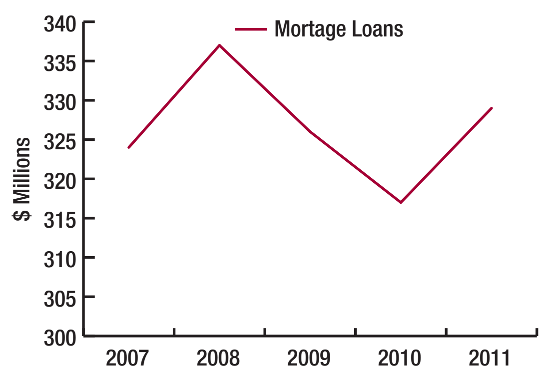
U.S. Life/Health – Common Stock Holdings (2007-2011)



Source: BestLink® – Best's Statement File, L/H, US

Exhibit 5

U.S. Life/Health – Mortgage Loan Holdings (2007-2011)



Source: BestLink® – Best's Statement File, L/H, US

Conclusion

A.M. Best is carefully monitoring how the macroeconomic environment and company initiatives to strengthen earnings are affecting the life and annuity sector's absolute and risk-adjusted capitalization. Deterioration in either capital measure could affect A.M. Best's opinion on the sector's current stable rating outlook. Other pressure points that could result in an outlook change from stable to negative include:

• Aggressive changes in company investment allocations causing greater volatility in earnings trends;

• Decline in BCAR scores as a result of higher C-1 risk charges without offsetting capital support;

• Divestiture of core insurance operations which had previously provided diversification in earnings/reserves to offset unprofitable business segments driven by the low-interest rate environment;

• Deterioration in macroeconomic conditions resulting in a material upward spike in interest rates and inflation, leading to large market value declines and/or credit losses within insurers' investment portfolios;

• Mid- to longer-term spread compression from low interest rates and lower reinvestment yields which begins to materially impact insurers' operating profiles for a sustained period.

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