# Impact of the Financial Crisis on the Insurance Industry

Marty Klein,
*Managing Director*
Tel. 212.526.8357
Email: martin.klein@barcap.com

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# Impact of the Financial Crisis on the Insurance Industry

## What a long strange trip it's been

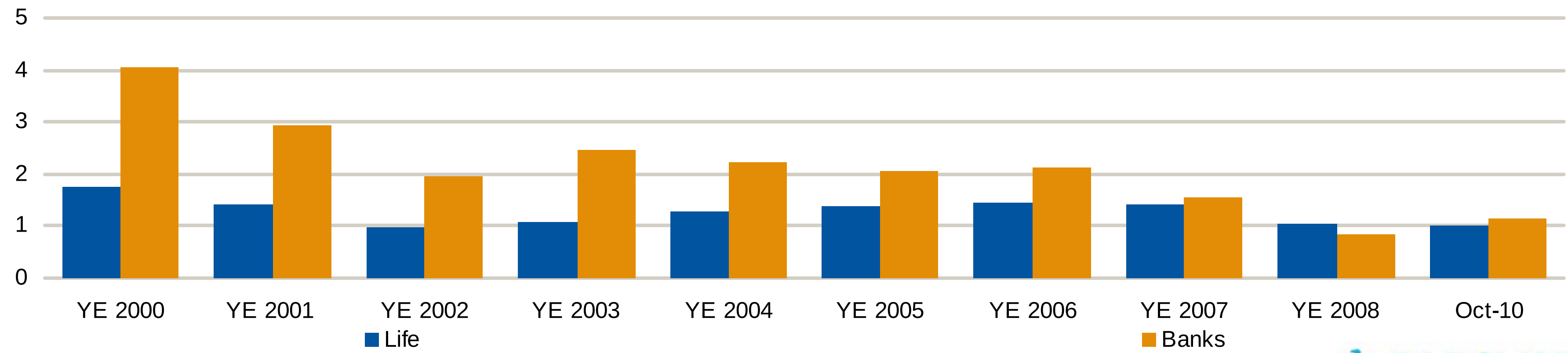
- The insurance industry has been at the center of the financial storm
- Balance sheets were devastated, some financial institutions went bankrupt or were forced to sell, and government and regulators took unprecedented action
- While some of the "lessons learned" are being put into practice, others are more difficult to implement and require strong coordination internally or with regulators
- Today we will discuss:
  - Challenges from the capital markets for insurers
  - Government, regulatory and accounting responses to the crisis
  - Lessons learned in portfolio, product, and risk management
  - Long term implications

# Then and Now: Stock Performance Tracks with Capital Markets Sentiment

## Back from the brink

### Selected Life Insurers' and Banks' Stock Price


### Historical Price to Book Ratios




*Source: Barclays Capital, Bloomberg, and FactSet. Data as of 10/14/2009.*

1. *Life insurers include Prudential, MetLife, Lincoln, Principal, Protective, Genworth, AEGON, Axa, Assurant, Torchmark and Unum.*
2. *Commercial and Investment Banks include Citigroup, J.P. Morgan, Bank of America, Wells Fargo, Bank of NY Mellon, Capital One, Goldman Sachs and Morgan Stanley.*

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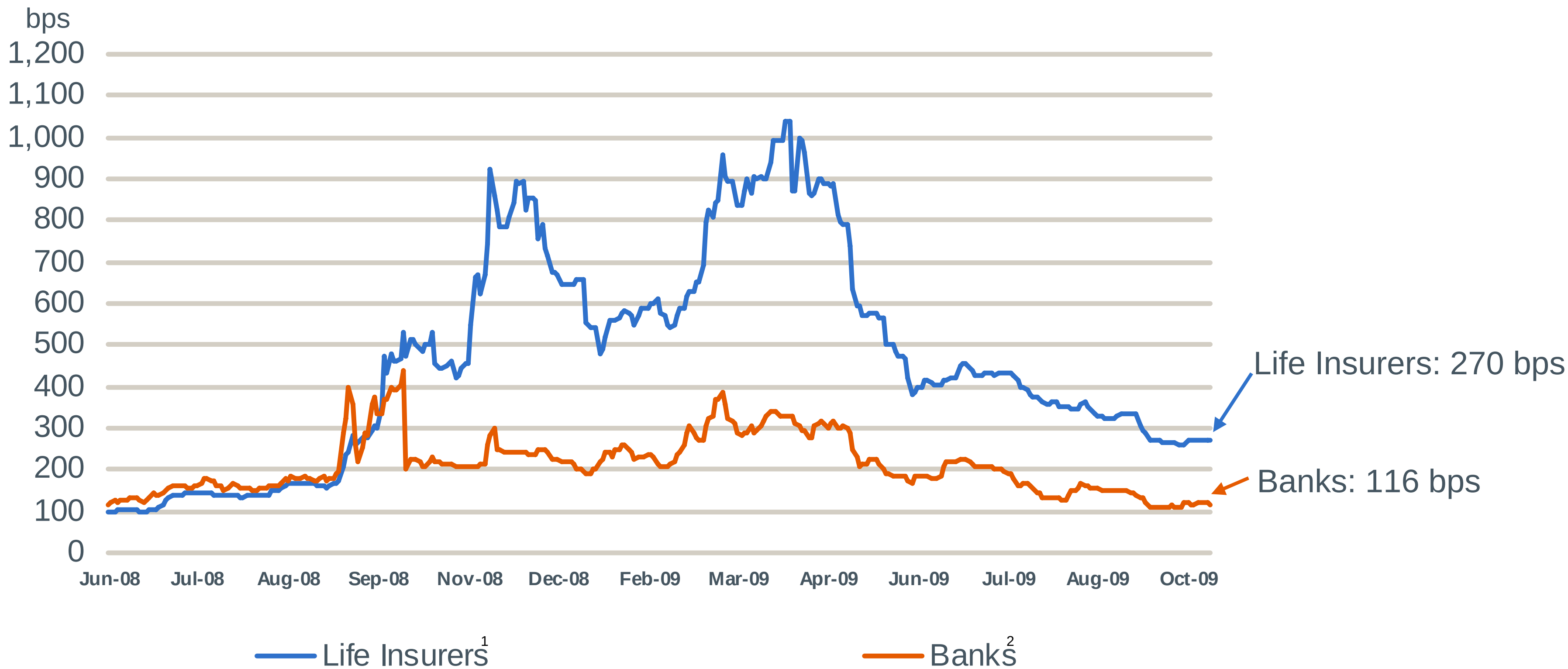
# Credit Spread Performance Improving

## Insurance spreads are multiples of historical levels, but have tightened dramatically from early 2009 levels

### Selected Life Insurers' and Banks' CDS Spreads (bps)

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# What Haven't the Markets Liked About Life Insurers?

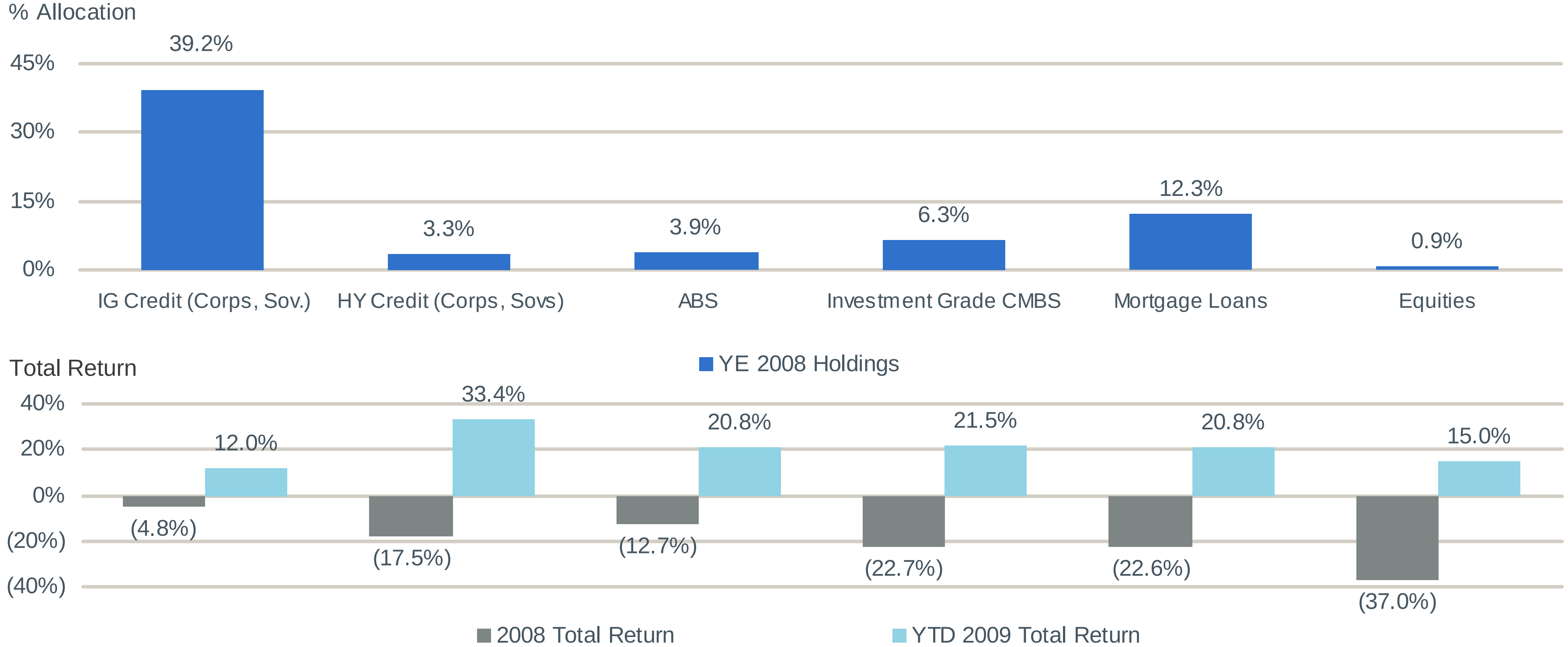
**Reasons for the negative sentiment towards life insurers included:**

- Asset Portfolios (e.g. subprime, commercial real estate / CMBS)
- Product Issues (e.g. variable annuities)
- Opaque and Inconsistent Accounting (e.g. OTTI)

# Insurers' Investments Were Hit Hard in 2008…

## So Much for Diversification…

**Life Insurers: % 2008 Allocation and 2008/YTD 2009 Total Return**




| Index: | US Credit "A" Total Return | "Ba" U.S. High Yield | U.S. Securitized – ABS | Investment Grade CMBS | Commercial Whole Loan | SPTR |
|---|---|---|---|---|---|---|

*Source: Insurance Company Statutory filings as of YE2008. Barclays Capital Indices, and Bloomberg. YTD 2009 returns as of August 31st, 2009. Selected Life insurers include MetLife, AIG, TIAA, Prudential, NYL, NML, AEGON, John Hancock, ING, MassMutual, AFLAC, Lincoln National, Principal, Allstate, Hartford, Allianz, Genworth, AXA, Jackson National and State Farm.*

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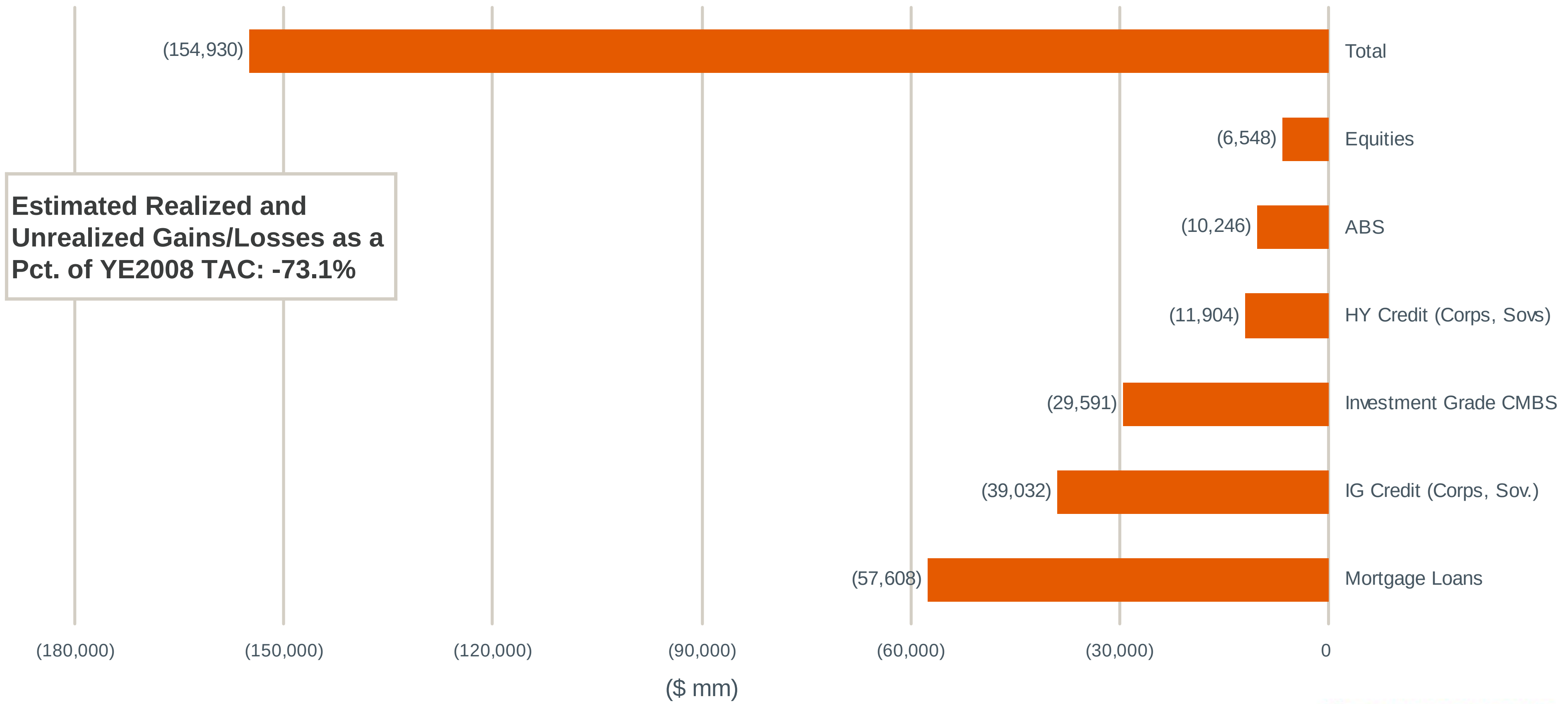
# …Leading to Substantial Potential Swings in Capital

## Year-end 2008 Estimated Realized and Unrealized Gains/Losses ($mm)




*1. Insurance company holdings as of year-end 2008 and 2008 total return.*
*Source: Insurance Company Statutory filings as of YE2007 and YE2008.*
*Selected Life insurers include MetLife, AIG, TIAA, Prudential, NYL, NML, AEGON, John Hancock, ING, MassMutual, AFLAC, Lincoln National, Principal, Allstate, Hartford, Allianz, Genworth, AXA, Jackson National and State Farm.*

# Variable Annuity Exposures Took A Toll

## Select Insurance Companies' Disclosure on Financial Impact of Declining Equity Markets

**2008 Fiscal Year Impact**

*"...the company's full year 2008 net loss reflected a $932 million after-tax charge, taken in the third quarter, related to the company's revision of its estimates of future gross profits, commonly referred to as deferred acquisition cost (DAC) unlock"*

**Hartford Life**

*"Lowered future variable annuity and variable universal life profit expectations based on continued depreciation in contract values and historical equity market return patterns, which resulted in a $252 million pretax, non-cash charge in deferred acquisition costs (DAC) and deferred sales inducement costs (DSIC)"*

**Ameriprise**

*"$2,407 million of losses were due to the post tax increase in segregated fund guarantee liabilities, comprised of $1,805 million for the reduction in the market value of the funds being guaranteed and $602 million because the sharp drop in swap interest rates reduced the discount rates used in the measurement of the obligation"*

**Manulife**

*"$587mm of losses attributed to minimum guarantee reserves strengthening and accelerated amortization of DPAC and lower fees"*

**AEGON USA**

*"$708 million increase in DAC and VOBA amortization" (VA and VUL)*

**MetLife**

*"A $210 million unfavorable prospective unlocking from assumption changes of DAC, VOBA, DSI, DFEL and reserves for Guaranteed Death Benefit (GDB) riders in 2008"*

**Lincoln Financial Group**

*"Current quarter [4Q 2008] results include charges of $498 million representing a net increase in amortization of deferred policy acquisition and other costs reflecting an updated estimate of profitability for this business, and $409 million representing a net increase in costs associated with guaranteed minimum death and income benefits"*

**Prudential**

*Source: Company 10Ks and press releases.*

# As Riders Have Been Underpriced....

## Seller Beware: The economic value of riders to insurers is negative

| | Fee Rider Charged[1] | Estimate of Economic Value | Difference |
|---|---|---|---|
| **Death Benefit** | | | |
| **2006** | ~30-50 bps | ~40-50 bps | ~0-20 bps |
| **4Q2008 /1Q 2009** | ~0 bps (often bundled with other fees) | ~140-150 bps | ~140-150 bps |
| **Withdrawal Benefit** | | | |
| **2006** | ~45-75 bps | ~60-80 bps | 0-35 bps |
| **4Q2008 /1Q 2009** | ~60-90 bps | ~260-280 bps | 170-220 bps |

- As a result of the increase in hedging costs driven by the current volatility regime, companies are scaling back feature complexity, increasing M&E fees, and in certain cases pulling products altogether
- We expect other modifications to products including simpler, easier to hedge investment options and reduced fund switching

*1. Assumptions: Volatility to average term: ~15% in 2006, ~28% in 2009; Interest Rates to average term: ~5.1% in 2006, ~2% in 2009 Mortality table for a 55 year old male; Standard lapse and weighted average life assumptions.*



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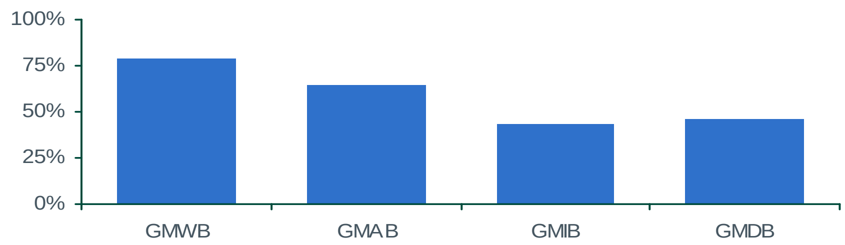
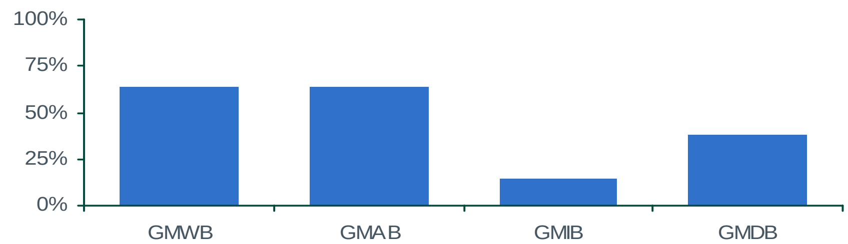
# And Insurers' Risk Retention Was Significant

- Historically, some insurance companies have not hedged all of their exposure because of accounting implications or the high costs of hedging relative to product pricing
- Others hedged long-term exposure through short-term options, providing a less efficient match

## Companies Hedging Against Market Volatility(1)




## Companies Hedging Against Interest Rates(1)




## Estimated Greek Exposures In the Marketplace Attributed From Variable Annuities(2)

| | Total Exposure | Percent Hedged | | | | | |
|---|---|---|---|---|---|---|---|
| | 1.5 Trillion | 25% | 40% | 50% | 60% | 70% | 80% |
| **Delta** | **$288.13 bn** | $216.1 bn | $172.88 bn | $144.07 bn | $115.25 bn | $86.44 bn | $57.63 bn |
| **Vega (1%)** | **$10.0 bn** | $7.5 bn | $6.0 bn | $5.0 bn | $4.0 bn | $3.0 bn | $2.0 bn |
| **Rho (1%)** | **$44.0 bn** | $33.0 bn | $26.4 bn | $22.0 bn | $17.6 bn | $13.2 bn | $8.8 bn |

- The unhedged risk outstanding is in the range of tens of **billions**, whereas the capacity for hedging in the market is in the range of tens of **millions**

1. *Source: Society of Actuaries Survey*
2. *Source: Barclays Capital. Using S&P 500 European-style puts. Market parameters as of 09/08/2009.*



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# Insurers Have Perceived Opaque Accounting Rules

## Mark-to-Market vs. Book Value Accounting

- FAS 115 requires that most securities held be marked-to-market, but does not allow liabilities to be marked-to-market
  - Financial crisis highlighted the tug of war between analysts and insurers on how to view their underwater portfolios
  - Controversy due to very depressed asset valuations but relatively low level of impairments
- FAS 157 mandates exit pricing for securities held
  - Gives liquidation value to company rather than going concern entity;
  - Market pricing reflects not only perceived credit losses but also illiquidity
- These rules may have exacerbated the dramatic dislocation in the market
  - FAS 157 forces low valuations, as “exit pricing” in times of distress encompasses both higher credit and illiquidity costs
- OTTI which has been the cause of much focus and confusion and has partially been addressed by the FASB and the NAIC

# Other-Than-Temporary-Impairment

## OTTI has been a Four Letter Word

- OTTI has been inconsistently applied among insurers:
  - Impairment thresholds (e.g. decline of 20% or more for six months) have been disregarded by many in the current market environment
  - Little consistency in practice across the insurance industry has created confusion and increased difficulty in comparing financial performance
- Concern over demonstrating “intent and ability to hold to recovery” had led to a “hold your losers” approach for some companies
  - New FASB guidance
    - Trigger for OTTI has changed – moving from “intent and ability to hold” to “no intent or requirement to sell”
    - In recognizing an OTTI when there is no intent to sell, now only the credit loss portion must be recognized in earnings. Loss related to market liquidity, rates and other factors will remain in Accumulated Other Comprehensive Income (AOCI)
  - On the statutory side, the treatment is similar for structured securities

# Managing for Accounting Results vs. Economic Results

## Winning the Accounting Battle, Losing the Economic War

- There are several areas of conflict in managing for GAAP financial results vs. economic results:
  - SFAS 133 – difficulty in getting hedge accounting
    - Discourages macro hedging and other risk management approaches due to GAAP earnings volatility
  - Liability risks not consistently or accurately reported (e.g. Variable Annuities)
    - Has led to inconsistent risk management for similar risks (duration closely matched in general account, often unhedged in variable annuities)
    - Inadequate pricing often has no immediate financial reporting impact
  - OTTI – tensions to avoid asset write-downs
    - Encouraged “hold the losers” mentality to avoid “tainting” other holdings
  - Treatment of investment income on bonds inconsistent with that of loans or with insurance liabilities (no concept of loss reserves for bonds)
    - Incents reaching for nominal spread vs. investing on a risk-adjusted basis

# Rating Agency Pressures....

## Charcoal Tinted Glasses

S&P, Moody’s, and Fitch have *maintained* a **Negative Outlook** to the US Life Insurance Industry

| | |
|---|---|
| S&P | • The recession has dampened life insurers’ investment portfolios and earnings, while a lack of access to the credit markets has reduced their financial flexibility and put pressure on holding company liquidity<br>• Life insurers face less predictable consumer behavior risk on annuity withdrawals and higher reserve requirements, and as a result are struggling to implement new product changes, slowing any plans for growth |
| Moody’s | • Asset impairments and losses in the investment portfolios of life insurers are expected to continue, dampening industry profitability and capital adequacy |
| Fitch | • Investment losses are expected to continue in 2009 as concerns remain about deteriorating credit and equity markets; corporate default records will be tested in 2009 and 2010 |

*Rating Agency Outlooks as of September 1, 2009.*

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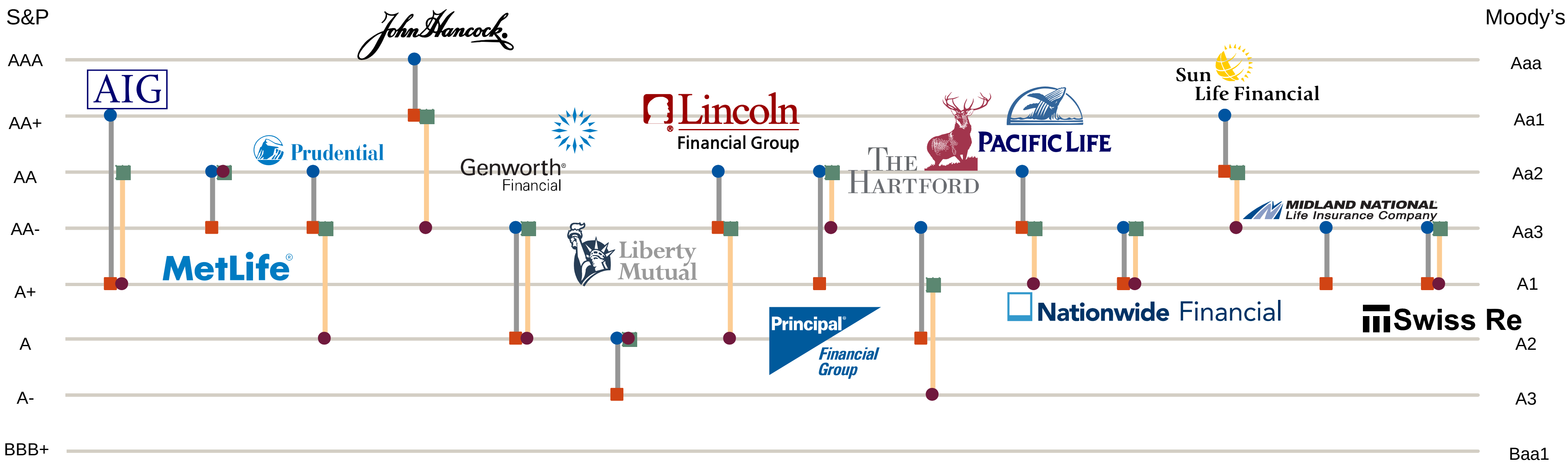
# Rating Agency Views

## 'A' is the new 'AA'
## Rating agencies continue downgrades with many companies on negative outlook

**S&P and Moody's Financial Strength Ratings – Recent Downgrades**




**S&P**
- Previous Ratings
- Current Ratings

**Moody's**
- Previous Ratings
- Current Ratings

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 *Source: S&P Ratings and Moody's Ratings from 2006 – August 31st, 2009.*

# Change in Capital and Surplus

**Life Industry Change in Capital and Surplus (in $ billions)**

| | 2007 | 2008 |
|---|---|---|
| Capital and Surplus (incl. AVR), Beginning | 226.0 | 240.6 |
| Operating Income | 24.9 | 3.9 |
| Net realized capital gains/(losses) | (0.8) | (38.0) |
| Net unrealized capital gains/(losses) | 1.1 | (29.9) |
| Paid in Capital | 2.0 | 36.3 |
| Dividends to Stockholders | (16.8) | (13.4) |
| Other | 4.2 | 9.0 |
| Capital and Surplus (incl. AVR), Ending | 240.6 | 208.6 |
| **$ Change in Capital** | **14.6** | **(32.0)** |
| **% Change in Capital** | **6.5%** | **(13.3%)** |

- In addition to the capital markets rebound, surplus levels have also seen increases in 2009 over 2008 as a result of a variety of permitted practices from state regulators
- Many of these practices are set to expire before year-end unless renewed

*Source: Moody's Weekly Credit Outlook, SNL*

# What Has Been the Response to the Financial Crises?

**All hands on deck...**

- Federal Government Programs
- State Regulator Steps
- Accounting Changes
- Life Industry Actions

# Throughout 2008 and 2009, the Government Took Extensive Action...

## Alphabet Soup

- The Federal Reserve in conjunction with Treasury initiated unprecedented programs to increase liquidity and improve market confidence

| *Troubled Asset Relief Program* | *Fed's Purchase Program* | *CPFF/AMLF/MMIFF* | *Term Asset-Backed Securities Loan Facility (TALF)* | *Term Auction Facilities (TAF)* | *Primary Dealer Credit Facility (PDCF)* | *Term Securities Lending Facility (TSLF)* | *Public/Private Investment Funds (PPIFs)* |
|---|---|---|---|---|---|---|---|
| *A number of programs aimed at providing stability to financial institutions through a variety of means as well as capital injections for the automotive industry* | *Increase purchase of MBS by $750 bn; increase purchase of agency debt by $100 bn; purchase up to $300 bn of Treasuries* | *Funding for 3mo CP and ABCP / funding to banks to finance purchases of ABCP from MMF / funding to purchase certain securities from MMF* | *Supports consumer finance securitization markets – credit cards, auto loans, small business loans, student loans, recently expanded to CMBS* | *Fed auctions 28 or 84 day funds to depositary institutions. Same collateral as discount window* | *Fed provides overnight loan facilities against collateral eligible in tri-party repos to primary dealers of the NY Fed via their clearing banks* | *28-day Treasury securities for loan against collateral including IG corp, muni, MBS or ABS on a competitive single-price auction* | *Investment Fund utilizing public and private capital and managed by private asset managers whose purpose is to acquire legacy real-estate related assets from banks* |

- In May Treasury announced that it would offer TARP funds to six insurers, two of which accepted funds
- While many government programs did not provide direct benefits to insurers, the benefits to the capital markets did help significantly

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# ...And is Also Pushing for Greater Regulation Domestically.....

**Major implications for large, interconnected financial firms (LIFFs), including insurers...if interested parties can come to an agreement**

- Under the Obama proposal released early this year, insurance companies would continue to be regulated by state insurance regulators
- Office of National Insurance within Treasury to gather information and coordinate policy among state regulators
- LIFFs would be deemed Tier 1 Financial Holding Companies (TIER 1 FHCs)
  - Consolidated supervision of Tier 1 FHCs will extend to the parent company and all subsidiaries with regulatory capital and liquidity standards applied to the entire entity
- Many of the details have yet to be determined as interested parties negotiate their terms

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# As Well as on an International Level...

## Regulators are undertaking widespread reform initiatives affecting every aspect of the financial sector

### Pittsburgh G-20 Agreement

- By year-end 2010, international rules on quantity and quality of capital
  - To be implemented by year-end 2012
- Countercyclical buffers
- Higher capital requirements for risk products and off-balance sheet activities
- Strengthened liquidity requirements
- Forward provisioning
- Strengthened supervision of banking sector
- Internationally harmonized leverage ratio to supplement risk-based framework
- All G-20 financial centers to adopt Basel II by 2011

### Enhancements to Basel II Framework

- Firm-wide governance and risk management
- Off-balance sheet and securitization exposures
- Managing risk concentrations
- Managing risks over the long-term
- Compensation practices
- Changes to trading book requirements
- Capital standards:
  - Additional buffers
  - Quality of capital
  - Leverage ratio backstop

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# State Regulators Also Took Steps to Aid Surplus Positions....

**In the year 2008, over 80 companies benefitted from increases to surplus as a result of new permitted practices for a combined effect of approximately $8.8 billion[1]**

| Initiative | Capital Relief |
|---|---|
| Mortgage Experience Adjustment Factor (MEAF) | Tightening the range of the MEAF from 50% - 350% to 75% - 125% |
| Deferred Tax Assets | Increasing the limitations on non-admitted DTAs that can be introduced into the Balance Sheet |
| Variable Annuities | Elimination of use of stand-alone asset adequacy analysis and Standard Scenario |
| Life Reserves | A number of initiatives aimed at providing capital relief related to life insurance liabilities |
| Derivatives Risk Mitigation | A proposal aimed at providing capital relief for transactions that use derivatives that pare asset risk |

- States that granted capital and reserve relief on an individual basis include Connecticut, Illinois, Iowa, Kansas, Missouri, Nebraska, Ohio and Tennessee



*Source: "Permitted practices give added boost to already-stabilizing life surplus" ; SNL, 09/02/2009*

# Dealing With RMBS Exposure

**Regulators are addressing the issue on two fronts, via an RMBS "notching" proposal and accounting treatment for re-securitizations**

**RMBS "Notching" proposal**

- The notching proposal has evolved into a modeling proposal that assigns RBC designation based on severity of loss
- The proposal is making its way before the working groups / committees and could see some resolution before the December NAIC meeting
- If approved could potentially provide tens of billions of RBC relief

**Re-REMIC Accounting**

- Issue of full loss vs. partial loss recognition is being debated by regulators
  - If partial loss decision is reached, insurers would be incented to re-securitize portfolios to obtain RBC relief

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# The FASB Also Weighed In....

## Fixing the gaps in GAAP

| Initiative | Overview |
|---|---|
| Consolidation of QSPE's | Post December 31st QSPEs will have to be consolidated which could place pressure on leverage and liquidity ratios |
| Full MTM on Assets Securitized | Post December 31st securitizations will trigger full loss recognition under GAAP |
| OTTI | Bifurcation of "credit-related" losses and "non" will provide greater clarity to the balance sheet. |

# Insurers Also Took Action

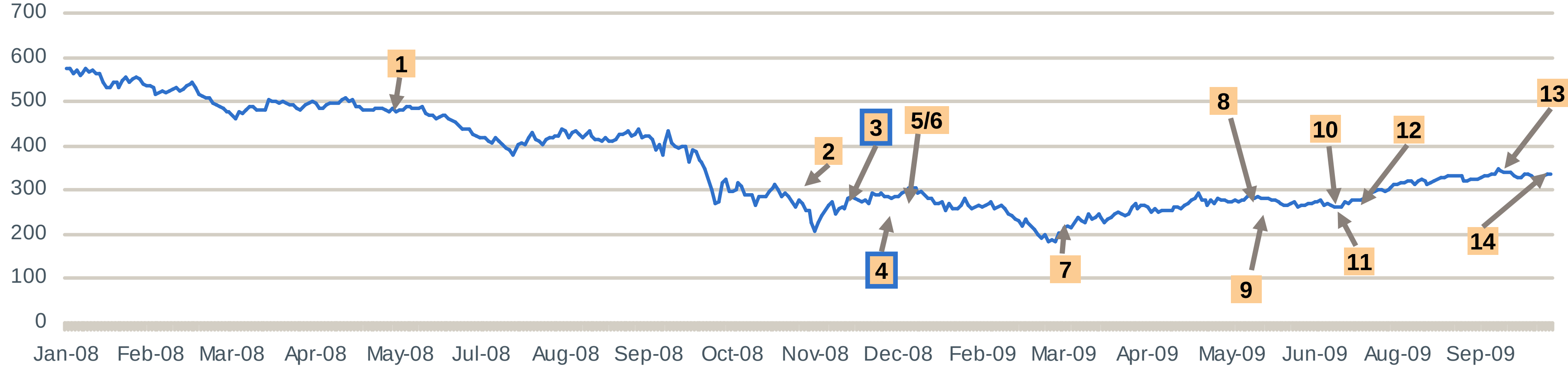
## Fighting back

- Insurers pulled several different levers to repair balance sheets and reposition themselves in the deteriorating market environment

| | |
|---|---|
| Capital Raises | • A number of insurers accessed the debt and equity markets for opportunistic financing and debt/equity/hybrid exchanges |
| Investment Portfolio Shifts | • Greater focus on risk reduction, warehousing liquidity and preserving/building capital |
| Enterprise Risk Management | • Greater focus on macro hedging to minimize tail risk, especially for equities and interest rates |

# Capital Raises by Insurance Companies: 2008 – 2009 Equity Activity

## Brother can you spare a dime?




| | Company | Date | Amount (bn) | Price |
|---|---|---|---|---|
| 1 | AIG | 5/12/2008 | $6.50 | $38.00 |
| 2 | Metlife | 10/8/2008 | $2.30 | $26.50 |
| 3 | ING | 10/20/2008 | $13.40 | -(1) |
| 4 | Aegon | 11/30/2008 | $3.00 | -(1) |
| 5 | Manulife | 12/2/2008 | $0.90 | $19.40 |
| 6 | Manulife | 12/2/2008 | $0.80 | $19.40 |
| 7 | Swiss Re | 2/5/2009 | $2.56 | -(2) |
| 8 | Principal Financial | 5/11/2009 | $1.00 | $19.75 |
| 9 | Protective Life | 5/14/2009 | $0.12 | $9.00 |
| 10 | Prudential | 6/3/2009 | $1.40 | $39.00 |
| 11 | Ameriprise | 6/11/2009 | $0.90 | $25.00 |
| 12 | Lincoln National | 6/15/2009 | $0.60 | $15.00 |
| 13 | Genworth | 9/15/2009 | $0.56 | $11.75 |
| 14 | Conseco | 10/13/2009 | $0.28 | -(3) |

*Source: Bloomberg; SNL Insurance Underwriter Index.*
*Note: Blue highlight indicates a government transaction.*
1. *Tier 1 Capital Securities from Dutch Government.*
2. *Perpetual capital instrument sold to Berkshire Hathaway.*
3. *Capital plan involved the purchase of 16.4mm shares and warrants to purchase 5.0mm shares of common stock for $77.9mm by Paulson & Co. as well as a separate common stock offering of $200mm.*

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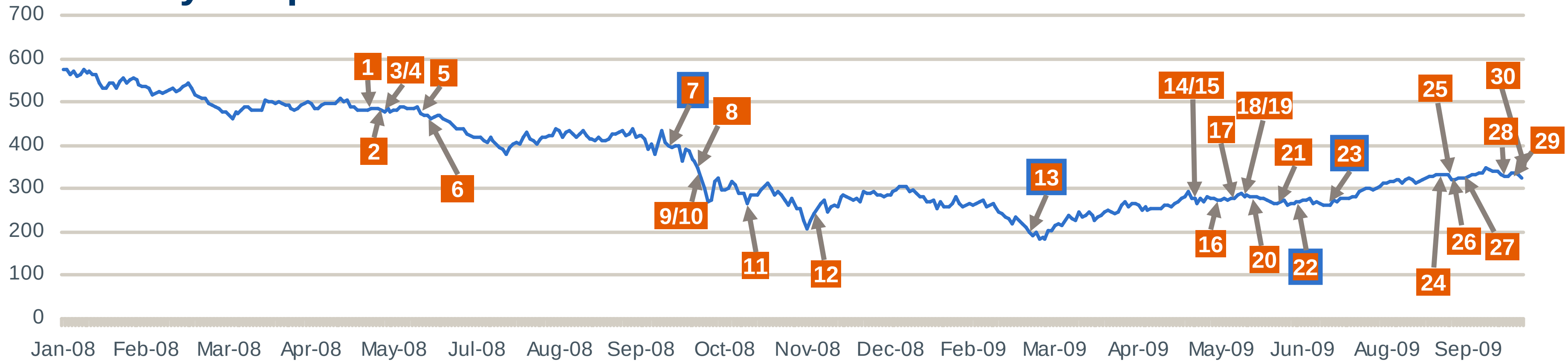
# Capital Raises by Insurance Companies: 2008 – 2009 Debt Activity

## Brother can you spare a dime?




| | Company | Date | Amount (bn) | Spread | Maturity |
|---|---|---|---|---|---|
| 1 | AIG | 5/16/2008 | $5.88 | - | - |
| 2 | AIG | 5/20/2008 | $8.00 | 354 bps | 5/15/2058 |
| 3 | AIG | 5/22/2008 | $2.87 | 386 bps | 5/22/2038 |
| 4 | AIG | 5/22/2008 | $2.10 | 385 bps | 5/22/2038 |
| 5 | Hartford | 6/6/2008 | $0.50 | 425 bps | 6/15/2038 |
| 6 | Allianz | 6/10/2008 | $2.00 | - | - |
| 7 | AIG | 9/23/2008 | $85.00 | - | - |
| 8 | Axa | 10/5/2008 | $1.03 | - | - |
| 9 | Hartford | 10/6/2008 | $1.75 | -1 | 10/15/2038 |
| 10 | Hartford | 10/6/2008 | $0.75 | - | - |
| 11 | CNA Financial | 10/27/2008 | $1.25 | - | - |
| 12 | AIG | 11/25/2008 | $40.00 | - | - |
| 13 | AIG | 3/1/2009 | $26.00 | - | - |
| 14 | Allstate | 5/13/2009 | $0.70 | 430 bps | 5/16/2019 |
| 15 | Allstate | 5/13/2009 | $0.30 | 420 bps | 5/16/2014 |

| | Company | Date | Amount (bn) | Spread | Maturity |
|---|---|---|---|---|---|
| 16 | Metlife | 5/25/2009 | $1.25 | 375 bps | 6/1/2016 |
| 17 | Mass Mut | 5/27/2009 | $0.75 | 437 bps | 6/1/2039 |
| 18 | Metlife | 6/3/2009 | $0.40 | L + 190 bps | 6/10/2011 |
| 19 | Metlife | 6/3/2009 | $1.00 | 280 bps | 6/10/2014 |
| 20 | Ameriprise | 6/8/2009 | $0.30 | 375 bps | 6/28/2019 |
| 21 | Lincoln National | 6/17/2009 | $0.50 | - | - |
| 22 | Hartford | 6/26/2009 | $3.40 | - | - |
| 23 | Lincoln National | 7/10/2009 | $0.95 | - | - |
| 24 | Prudential | 9/10/2009 | $1.50 | Mixed[2] | Mixed[2] |
| 25 | Markel Corp | 9/17/2009 | $0.35 | 375 bps | 9/30/2019 |
| 26 | National Life of VT | 9/18/2009 | $0.20 | - | 9/15/2039 |
| 27 | Unum Group | 9/25/2009 | $0.35 | 417 bps | 9/30/2016 |
| 28 | Guardian | 10/1/2009 | $0.40 | 350 bps | 9/30/2039 |
| 29 | New York Life | 10/5/2009 | $1.00 | 275 bps | 11/15/2039 |
| 30 | Protective Life | 10/15/2009 | $1.00 | 437 bps | 10/15/2039 |

*Source: Bloomberg; SNL Insurance Underwriter Index.*
*Note: Preferred and preferred-like securities are grouped as "debt" for purposes of the analysis; blanks, therefore, indicate that the security was not typical debt in that it did not price to a particular benchmark with a stated maturity; blue highlight indicates a government transaction.*
*1. 10% Junior Subordinated Notes callable at par after 10 years sold to Allianz SE.*
*2. $600mm 3.625% 3-year at T+225 bps and $900mm 4.75% 6-year at T+250 bps.*

# Current Insurance Investment Trends

## Cash was King in 2008 and early 2009

- Given the difficult markets and need to preserve capital, many insurers increased allocations to: cash, Treasuries and agencies, high quality investment grade corporates
- Commercial mortgage loan origination from insurers also dropped significantly in many cases (but a few companies found opportunities)
- Several companies sold down, exited, or hedged public common stock portfolios in 2008 and early 2009
- The historical increase in alternative investments has reversed for a time due to high capital charges and issues with hedge funds and private equity (though hedge fund performance has come back in 2009)
- 2009 saw the return of insurers to the debt markets
  - Insurers accounted for ~25% of buyer base of investment grade offerings this year, which is consistent with previous years (very little participation in high yield offerings)
  - Insurers also participated in TALF-eligible issuances, accounting for 10% - 15% of the buyer base of Barclays' issuance volume

# Life Insurers Asset Allocation Trends

## Top US Life[1] Insurer Portfolio Allocation Trends

| | 2007 | 2008 |
|---|---|---|
| **Liquidity** | | |
| *Cash & Short Term* | 2.5% | 4.9% |
| *US Government & Agencies* | 3.0% | 3.7% |
| **Total** | **5.4%** | **8.7%** |
| | | |
| **IG Corporates** | **41.0%** | **41.4%** |
| **HY Corporates** | **4.6%** | **4.3%** |
| | | |
| **Securitized Products** | | |
| *MBS* | 12.2% | 11.0% |
| *Structured Finance* | 11.8% | 11.0% |
| **Total** | **24.0%** | **22.0%** |
| | | |
| **Mortgage Loans** | **12.6%** | **12.3%** |
| | | |
| **Equities and Alternatives** | | |
| *Unaffiliated Common Stock* | 1.3% | 0.9% |
| *Schedule BA* | 4.4% | 4.2% |
| **Total** | **5.7%** | **5.0%** |

- Almost all of the top 20 life insurers increased their “liquid” holdings, and several made increases in the order of 100% - 300% of 2007 year-end holdings

1. *Top 20 Life companies are based on greatest General Account assets according to each year . As of YE2008 are: MetLife, AIG, TIAA, Prudential, NYL, NML, AEGON, John Hancock, ING, MassMutual, AFLAC, Lincoln National, Principal, Allstate, Hartford, Allianz, Genworth, AXA, Jackson National and State Farm.*

# Insurers Also Focused on Capital Preservation

## Shield not yield

| Capital Management |
| --- |

- Repositioning asset portfolios
- Hedging Fixed Annuities (C3 Phase I)
- Hedging Variable Annuities (C3 Phase II)
- Selling equities or hedging exposure in capital efficient structures
- Restructuring RMBS and CMBS portfolios to mitigate impact of downgrades
- Managing liabilities (funding agreement buybacks)

# Managing Insurance Businesses in the Medium to Long-term

**Going forward we expect some significant changes to portfolio, product, and risk management largely due to the lessons learned from the market environment over the past year**

- *Continued focus on liquidity and capital*
  - While most insurers would agree that the environment has improved, risk aversion has increased and capital and liquidity are still dear
- *Greater focus on Enterprise Risk Management*
  - More emphasis on looking at risks on a holistic basis, and the correlation between these risks in stressed environments
- *Product re-pricing, re-design, or retreat*
  - Taking capital markets risks into greater account at the expense of market share
- *Push for greater alignment between accounting and economics*
  - Several proposals underway that could drive this goal

# Enterprise Risk Management

**The current environment has accelerated the move from theoretical analysis to practical implementation**

- Shift in focus by the marketplace from earnings growth to capital preservation has given more latitude to risk managers

| | |
|---|---|
| Macro Hedging | • Companies have hedged or are looking to hedge exposure to equities, credit, and interest rates |
| VA Risk Management | • Losses and market concerns have forced insurers to revisit product design and hedging strategies |
| ALM | • Concerns about future inflation from government actions leading to focus on hedging inflation risk in liabilities or hedging rising interest rates |



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# Enterprise Risk Management Frameworks

## Lessons Learned

- Risk management for life insurers is more complicated than for other financial institutions
  - Insurers must manage risks over the short-term as well as long-term (50+ years)
- Models should be a tool but not the only tool
  - Correlations can change dramatically, which is not always captured in models
- Insurers should factor risk management into product design
  - Products should not only be appropriately priced, but also have a viable investment and hedging strategy designed as part of the product development process
- Insurers need to be more active in hedging capital markets risk
  - Capital markets risks are the most significant set of risks for most life insurers
  - Merely pricing in the risk without managing or hedging it is not a viable long-term strategy for most companies
- Accounting should not drive risk management

# Re-thinking the Variable Annuity Business

**Going forward, insurers are thinking hard about the risks sold via variable annuity policies, and how/if they will operate in this market**

- Several key ongoing and future themes for the variable annuity market include:

| | |
|---|---|
| Product Redesign | • Offerings likely to be simplified to reduce hedge basis risk<br>• Pricing adjusted to adequately reflect risk<br>• Actuarial (withdrawal) risk is still underestimated in many cases |
| Consolidation | • With the cost of capital expected to remain high, some companies will think about strategic alternatives for the variable annuity lines |
| Improved Hedge Practices | • Reinsurance/hedging addressed during design stage<br>• More complete hedging of risks |

# Re-thinking the Variable Annuity Business

## Re-price, re-design, or just retreat?

| Product | New Features |
| --- | --- |
| AXA Retirement Cornerstone | •Rollup rate / withdrawal rate based on 10 year treasury rates |
| Hartford Personal Pension Account (TBL) | •Premium based fees to fund B share commissions<br>•Personal Pension Account: guaranteed rollup & (competitive) annuitization rate at issue |
| John Hancock Annuitynote | •Forced index fund investment options to reduce basis risk / low fees |
| Transamerica | •3 rider charge options based on equity exposure |
| Prudential / Jackson National | •Target Volatility Funds |
| Allianz Investment Protector (GMAB) | •Fund allocation a function of time to maturity & moneyness<br>•Ratchet has a deductible |



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# The Ongoing Battle between Accounting and Economics

**Accounting and Capital Framework**

- If it intends to remain in current businesses, the life insurance industry needs a cash flow based accounting and capital model that the market both ***understands*** and ***trusts***
- Clarity and consistency in reporting asset performance is imperative
- Accounting needs to better align with economic reality regarding hedging and pricing

# Financial Management and Reporting Paradigms are Critical

## Accounting should reflect the results, not drive them

### Accounting and Capital Framework

- Current trend towards MTM poses challenges for the industry
  - Interest rate and credit volatility impact assets but not always liabilities
    - Should an insurer's widening credit spreads actually *decrease* values of its reported liabilities and increase earnings?
    - How should liabilities be "marked" when the insurer must pay "par" or "book"?
  - Amount of capital needed under an MTM approach would significantly increase, further cramming ROEs
  - MTM framework not conducive for spread lending businesses or long duration product lines
    - Deferred annuities, payout annuities and long-term permanent life insurance might not be economically attractive businesses under MTM
  - Would dramatically reduce insurer appetite for long-term bonds, providing major financing challenges to businesses and governments



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# Regulatory Framework Should be Revisited

## Regulating the regulators

| Regulatory Framework |
| --- |

Questions in assessing state regulation:

- How does the guaranty fund system stack up in an environment where confidence in financial institutions is lower and the potential for insolvencies is higher?
- Is *every* state insurance department able to assess and regulate national or global businesses which also involve significant capital markets risks?
- Are small but increasing differences in capital treatment among the states in the best long-term interest of the industry?
- How can the industry best lobby for regulatory change on a timely basis?
- Can the benefits of state regulation be maintained while integrating with federal regulatory oversight



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# The Life Industry Has Fundamental Strengths Despite the Challenges

- Insurance is a fundamental part of financial and risk management for individuals and corporations
- Risk protection and savings products will not become obsolete
- Insurance liabilities are more stable and “stickier” than those of other financial institutions
- Public perception of the life insurance industry is generally better than that of other financial institutions
- Insurance industry plays a vital role in the economy by providing financing to businesses and governments



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