

The Impact of the Current Financial Crisis on the Life Insurance Industry

Insight from Nease, Lagana, Eden & Culley, Inc. – Atlanta, GA

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There have been a number of recent headlines warning that life insurers may be the next victim of the crisis crippling world markets. With the stock prices of major life carriers down dramatically, it is clear that fear and an overall lack of confidence in our financial markets are ruling each trading day.

Policyholders are understandably concerned by recent events. It is natural to think if a life insurer's stock price has dropped 40% in a week that the contract you hold may be in jeopardy. However, it is important to distinguish between the interests of stockholders and policyholders.

Stockholders, which recently suffered through a week in which life insurance stocks plunged an average of 30%, are focused on the future earnings of insurance companies. Price declines across life insurance stocks reflect that the markets expect higher capital costs and declining investment portfolio returns to erode the earnings that shareholders may have expected. A declining stock price does not directly impact the operations of the company with respect to policyholders; however, it does indirectly impact the amount and cost of capital that a company could raise should the need arise.

Policyholders are focused on solvency: a life insurer's ability to honor the contract in place and pay a claim if submitted. Again, a declining stock price does not directly impact a carrier's solvency. In fact, there are a number of safeguards (noted below) that may provide policyholders meaningful comfort in volatile times. To look at it a bit differently, when you buy insurance you are not buying the stock of the insurance company. Instead, you are purchasing an asset that is subject to strict regulations designed to protect policyholders.

Conservative Reserves and Capital: Life insurers are required to hold reserves, within the regulated insurance subsidiary, to cover the cost of all future claims. The required reserves are calculated using a conservative method mandated by state law and regulation. In addition to conservative reserves, life insurers are also required by state law and regulation to hold a capital and surplus cushion. The size of this cushion is based on the types of investment risk in the insurers portfolio: the insurance risk the insurer is underwriting, the interest rate risk the insurer is exposed to, and the general business risk. If the capital and surplus of a company falls below a minimum required level, regulators are required to intervene and take specific action to protect policyholders.

High Quality General Account Assets: Since life insurers are required to hold additional capital and surplus for investments made in riskier assets, most insurance portfolios are comprised of the highest quality assets. These portfolios typically consist of a well diversified mix of high quality bonds, commercial mortgages, and real

estate. Additionally, life insurance company portfolios have much less leverage than banks or investment banks, which provides less portfolio volatility. Liquidity is also an important aspect of a life insurance company's portfolio. As part of their regulatory filings, life insurers are required to evaluate thousands of economic scenarios to ensure that the assets they hold will provide sufficient liquidity to meet policyholder liabilities under a wide range of economic circumstances. Therefore, even if the investments noted above (high quality bonds, commercial mortgages, and real estate) are adversely impacted by a market downturn, there is comfort that sufficient liquidity exists to meet policyholder liabilities. See Exhibit A below for additional details regarding general account asset diversification.

Separate Account Assets: For variable products, premiums invested in the separate account funds are segregated from the insurer's general portfolio. Generally speaking, state law protects separate account assets for the policyholders of the separate account. This provides an extra layer of protection for policyholders that is significant during times of broader financial instability. Since separate account assets are not comingled with the insurer's portfolio, creditors of the insurance company do not have claim to these assets.

Regulated Life Insurance Subsidiaries Have Protections In Place To Protect Policyholder Interests: Insurance regulations provide protections that essentially create a wall between a life insurance subsidiary and the parent company (and other affiliated subsidiaries). These regulations require that all assets, reserves, capital, and surplus must be held separately by the life insurance subsidiary. In addition, any transfer of capital or surplus to the parent company (or other affiliated subsidiaries) must be approved by regulators. Before approving such transactions, regulators are required to confirm that the transaction would not in any way impair the life insurance company's ability to pay policyholder benefits.

Despite Regulatory Safeguards, Fear Remains

There is lingering concern, however, regarding the impact of the broader market declines on life insurance investment portfolios, as well as the liquidity of the assets in these portfolios. Douglas L. Meyer, an insurance analyst at Fitch Ratings, commented: "Insurance companies tend to focus on high-quality investments." When the declines were mainly in the lower-quality investments, he said, the industry was relatively sheltered from harm. Now, though, "the depths of the current credit crunch are starting to affect the high-grade securities, so that's starting to affect the insurance companies more."

In addition to Fitch, Moody's, Standard & Poor's, and AM Best have put the US life insurance sector on negative watch, implying that carriers may need to raise capital to offset investment losses. These announcements are reflective of the uncertain direction of the current crisis. However, the write downs insurers have taken in response to the crisis—to date—have been within available capital and surplus.

For now, insurance company analysts, including Colin Devine of Citigroup, do not see an insolvency risk. In a report dated October 10, 2008 ("Sale of Life Insurance Stocks Vastly Overdone: Do Not Believe Any Names within Our Universe Face Insolvency"), Mr. Devine commented: "Despite the intense sell-off of life insurance stocks over the past week none of the companies within our universe face the type of financial stress that caused the problems of AIG. Mr. Devine covers all six of the publically traded M Partner Carriers.

AIG: Problems Not from Insurance Subsidiary

It is important for policyholders to remember that the AIG situation does not involve an impairment of the life insurance operations. AIG's troubles stem from a non-insurance entity, AIG's Financial Products subsidiary, that was issuing credit protection products. These products have suffered huge losses due to the current credit crisis. These are losses of shareholder value, not policyholder

value. The assets within AIG's life subsidiary are protected by regulation for the benefit of the life subsidiary and are sufficient to meet the life subsidiary's liabilities.

A Look Ahead

These are unprecedented times and because things can change at any moment nobody can accurately predict what may be next. As our government tries to restore confidence, and volatility continues, we learn more each day. Our Firm continues to monitor developments and engage carriers in conversations, as we continue to serve the needs of clients.

While uncertainty persists—even the security of money market accounts have been called into question—life insurance may offer a safer port in the current financial storm. The policyholder safeguards noted above, together with products offered by highly rated, financially strong carriers (as identified by ratings agencies), create—under the appropriate circumstances—an attractive opportunity.

Any exploration of opportunities in the life insurance market should be done in conjunction with an insurance advisor who understands the complexities of the landscape and the mechanics of the products available. Inforce service—which is provided after the purchase of the policy—is also critical. In a volatile environment, it is essential to continuously monitor policy performance and assess the impact of emerging trends.

Nease, Lagana, Eden & Culley, Inc., based in Atlanta, is a leading insurance advisor to the affluent. The firm is a Strategic Advisor to the Family Office Exchange and a Member Firm of M Financial Group.

Exhibit A: General Account Asset Diversification (Aggregate for Life Insurance Industry)

| ASSET DISTRIBUTION (%) | 2007 | 2006 | 2005 | 2004 | 2003 |
|-------------------------------|-------------|-------------|-------------|-------------|-------------|
| Bonds | 70.9% | 72.0% | 74.5% | 73.7% | 73.1% |
| Preferred Stocks | 2.2% | 2.2% | 0.8% | 1.2% | 1.1% |
| Common Stocks | 4.3% | 4.3% | 4.0% | 4.1% | 4.0% |
| Mortgages | 11.2% | 10.8% | 10.5% | 10.5% | 10.8% |
| Real Estate | 0.6% | 0.7% | 0.7% | 0.7% | 0.8% |
| Policy Loans & Premium Notes | 3.9% | 3.9% | 3.9% | 4.0% | 4.2% |
| Cash & ST Investments | 2.3% | 2.3% | 2.0% | 2.4% | 2.7% |
| All Other Invested Assets | 4.5% | 3.7% | 3.6% | 3.5% | 3.3% |
| Total Cash & Invested Assets | 100% | 100% | 100% | 100% | 100% |

| QUALITY OF BONDS | 2007 | 2006 | 2005 | 2004 | 2003 |
|--|-------------|-------------|-------------|-------------|-------------|
| Investment Grade Bonds | | | | | |
| NAIC Class 1 (S&P Equiv. AAA to A-) | 68.6% | 68.6% | 67.3% | 64.3% | 61.8% |
| NAIC Class 2 (S&P Equiv. BBB+ to BBB-) | 25.3% | 25.4% | 26.6% | 29.2% | 30.3% |
| Non-Investment Grade Bonds | | | | | |
| NAIC Class 3 (S&P Equiv. BB+ to BB-) | 3.5% | 3.4% | 3.6% | 3.7% | 4.3% |
| NAIC Class 4 (S&P Equiv. B+ to B-) | 1.9% | 2.1% | 1.9% | 2.0% | 2.4% |
| NAIC Class 5 (S&P Equiv. CCC+ to C) | 0.6% | 0.4% | 0.4% | 0.5% | 0.8% |
| NAIC Class 6 (S&P Equiv. C- to D) | 0.1% | 0.1% | 0.2% | 0.2% | 0.4% |

Source: Best's Statement File