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How Do the Analysts View Your Insurance Company?

Track: Investment

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Panelists: Rodney Clark
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Robert L. Riegel

Summary: Rating agency and equity analysts describe the quantitative and qualitative factors that drive insurance company ratings and stock market valuation levels. The analysts identify current issues and concerns for the companies they cover.

MR. DAVID J. WEINSIER: We have two representatives from rating agencies and a highly regarded financial analyst. Mr. Rodney Clark is the director in Standard & Poor's (S&P) financial services rating group. He has primary responsibility for the analysis of 15 life insurance companies in the United States. In addition, Rodney leads the life insurance team in analyzing and publishing S&P's views on the life insurance and life reinsurance sectors. Prior to joining S&P in 2000, Rodney's experience in the life insurance industry spanned more than 10 years, and he previously held several positions with Prudential and AON Re.

Mr. Eric Berg is Lehman's senior life insurance analyst. Prior to joining Lehman in the fall of 1999, Eric spent four years at CIBC Oppenheimer, where he was also the life insurance analyst and where for three consecutive years he was a member of the Institutional Investor All-Star Team. Prior to working at Oppenheimer, Eric was the property-and-casualty analyst at Bear Stearns.

Robert Riegel, managing director of Moody's insurance teams in America, is responsible for ratings and research of life insurance and property/casualty

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Note: All handout materials are available through the link on the table of contents.

insurance. Prior to working at Moody's, Robert worked as an actuary at Home Life Insurance. He graduated from the University of Pennsylvania with a B.S. in chemical engineering. Both Rodney and Robert are members of the Society. Eric is here as a guest.

I'm going to offer a little feedback on areas where our clients have come to us and feel like they need to focus on rating agency and analyst concerns. Then I'm going to hand it over to the three experts.

Many people are wondering right now whether they can trust financial information. I imagine that many insurance shareholders may feel the same way. They often don't understand where profits are coming from and sometimes feel that management is deliberately making financial statements more and more complex for no reason at all. While this is obviously not the case with every company, this does seem to be rather prevalent within the insurance industry.

Some recent events have posed some serious challenges for insurers and heightened their appreciation of risk. One event is the sluggish economy and slower-than-expected recovery. Here we're talking about several areas in the last several years that probably have had an impact on all of us and certainly on the companies for which we work. One is plunging interest rates, particularly impacting fixed annuities and universal life, regarding spread compression. You've got a volatile stock market, which certainly has impacted those of you on the variable side, and heightened credit losses from a couple of years back.

We've had changing regulatory requirements in terms of risk-based capital (RBC), reserve requirements and GAAP reserving. One commonality among all these items is stochastic projections. Stochastic modeling is virtually required and is becoming commonplace these days in terms of measuring risk.

We have asset/liability issues. We've got market-consistent valuation potentially to worry about in the coming years. Investment guarantees on your variable annuities are always a hot topic, as is managing spreads.

You've got changes in accounting standards. International accounting standards and fair value accounting are very hot topics. Shifting product preferences is another recent event.

Transparency is a buzzword within the industry these days. What exactly does "transparency" mean? Transparent financial reporting provides reliable, consistent and sufficiently detailed information that clearly reflects the underlying and current expected future condition of the company. This is what everybody wants to see, both externally and internally. Regulators and rating agencies (the external folks) are recognizing current inadequacies in financial reporting. They want to see more company-specific modeling of this risk exposure and capital needs. The same is true for the SEC and financial analysts.

As I mentioned, transparency is useful both internally and externally. The investment community has wanted greater transparency for some time now, and the two events of Enron and WorldCom have made the desire for greater transparency even more intense. Inside companies, management is looking for a clear line of sight between its actions and the impact on company performance and value-added measurements. Companies that perform value-added analysis certainly come to mind here.

What are financial analysts? What do they do? They certainly have an impact on you if you're a publicly traded company. They are centers of influence, in fact. They provide early warning indicators in times of trouble and typically focus on short-term earnings stability. That's their background. They provide regular coverage on company and industry news, often do the Q&A during quarterly earnings calls, participate in Investor Days and will also, if you're large enough, make a special company visit.

What are financial analyst issues? Recent capital market volatility has certainly heightened analysts' sensitivity toward your current financial reporting practices. Deferred acquisition cost write-downs has been a very hot topic. That probably hit the valley in 2003 when the market bottomed out in terms of variable products. Credit losses and write-downs, variable annuity guarantees and mortgage portfolio exposures have been very hot topics among the analysts as of late.

Your big four rating agencies—no surprises here—are S&P, Moody's, Fitch and A. M. Best. They have common issues here. They're certainly key influencers in the market. The rating that they assign to your company obviously carries quite a bit of impact. They have a particularly high influence on start-ups and mergers and acquisitions, and they provide warning signals when times are turbulent.

In the past, rating agencies have tended to lag in their views. They have been slow to react to the equity exposure and asset defaults. A lot of those hit companies that maybe came out of left field, if you will, were highly rated companies that really went down in a hurry. Rating agencies are often slow to change their position, once taken. If you get downgraded, then the amount of work you need to put in to regain that downgrade is often quite significant and can take quite a bit of time.

Recently we've seen increased attention paid to asset-liability modeling (ALM) issues. What's happening in the marketplace is that the big players, those that have a strong handle on their ALM and risk management, are setting the bar high. The rating agencies are noticing this and then going into the medium players, or anywhere near the top, and saying, "Hey, these companies are doing this for their ALM and risk management. You need to do it, too, or you're at risk for a downgrade." We've also heard rumors that S&P, in order to retain a rating or improve a rating, is requiring capital greater than their traditional 150 percent of RBC. I've heard numbers such as 300 percent.
With that, I'm going to pass it over to the experts.

MR. RODNEY CLARK: I'm going to talk through what it is that we look at in analyzing companies and assigning ratings, specific to our broad methodology. Then I'm going to focus on some of our key current issues of interest with respect to the industry.

Say you were to ask an audience, maybe not an audience as sophisticated as this, but an audience that casually looks at this industry, "What is it that rating agencies are interested in and concerned about?" Almost universally people would answer that capital is the figure. There's a very strong misconception out there that capital is *the* most important thing, maybe the only thing, that rating agencies are looking at in assessing a company's position. I even had one investment advisor say, "We're looking at a start-up reinsurer. We want to know how much capital it's going to take for a AA rating." The answer is that it's impossible, because you couldn't come up with a complete picture if you look at capital without looking at the other elements of a company's risk profile.

We do look at a number of different areas, under a very structured framework, in analyzing all of our companies, with a goal of assessing the long-term risk of a company, such as the risk that they won't be able to pay their policyholder obligations, pay their debt obligations, etc. It does encompass looking at a number of different areas to perform that broad view of a company's risk profile. Now, the things that I look at and the things that an equity analyst looks at are going to be perhaps entirely different because the motivations are very different. We're not looking at the rate of growth, whether a company's stock price is adequately reflecting its value or not, or how the market views weigh in.

We are looking at that risk and the long-term ability of a company to meet its obligations. We do that through this structured framework that I'm going to walk you through right now. The first category that we focus on is management and corporate strategy. This is probably the most subjective of the items that we look at in our ratings analysis. What are we talking about when we say "management and corporate strategy"? We're looking at a company's strategic positioning, which is how they've determined that they are going to approach the market. What is the company's strategy? Does the company have the right management team to effect that strategy? Does a company's management team take on undue financial risk in order to implement its strategy? Those are the types of things that we're evaluating. Does a company's strategy make sense, given the context of the marketplace? In doing this assessment, you have to look backward to some extent. What has management done historically? What's the track record? But you also have to be forward-looking. A company may have a strategy that has been very successful for the last 30 years, but the market has changed. Their strategy hasn't changed, and they're no longer positioned for success going forward. Those are the things that we evaluate in this area.

The next area is competitive position. If you've read any of our rating write-ups on companies, you'll notice that the competitive position portion of the write-up is almost universally the longest and most in-depth. This area is also somewhat subjective, but there are quantitative measures that you can pull into it. The goal of our analysis of competitive position is to identify where our company has competitive advantage or, in many cases, identify the fact that a company may not have a particular competitive advantage. We're looking at things like a company's market position in its chosen markets, the types of products and the types of product risk that they've taken on, the distribution system that they use, the geographic spread of risk, as well as the legal organizational structure. There are certain advantages and disadvantages to being a mutual. There are also certain advantages and disadvantages to being a stock company, certain advantages to being offshore, etc. So how does a company's competitive strategy fit with their organizational structure?

First and foremost what we're looking for in the next area is, can a company demonstrate its competitive advantage? A competitive advantage is something unique about the way a company competes in the marketplace that puts the company in a position either to produce a product similar to their competitors at a better cost or, conversely, to produce a product in a way that commands a premium in the marketplace.

I'll give you a couple of examples from outside the insurance industry of what we mean. Southwest Airlines, for example, is really the only large airline that's profitable today. The reason is that they have a certain competitive advantage in the way they've designed their approach to the market, the way they've built cost controls and so forth in their business model, so that they can charge less than competitors in many cases and still make more money because the business model is better. That's very difficult to replicate. On the flip side, think of Intel as a company that commands a premium for their products because of their reputation for quality and brand. Competitors cannot charge what Intel can charge for a similar product, and that's a strong advantage that contributes to Intel's bottom line.

The reason we're interested in identifying competitive advantage as a significant portion of our ratings process is that a company with a strong competitive advantage is going to see that realized in terms of stronger earnings than peer companies. Earnings feed into growth of the capital position. The capital can be invested to sustain or even improve upon a competitive advantage. It's a cycle that should be self-reinforcing if a company is effective at utilizing its competitive advantage.

In terms of where in the life industry we look for competitive advantage, first and foremost its distribution. Why do we think the distribution is where you see competitive advantage most clearly illustrated? Because it's very difficult to copy. If you have a distribution system (whatever channel you use that has been effective and that you've built up over time), it's very difficult for somebody to copy that. It may take years or even decades, depending on the type of distribution system.

That's very different from the product, which can be easily and quickly replicated in most cases. We find that very few companies are able to demonstrate that they have a product that brings them competitive advantage, but some are able to demonstrate some sustainable, distinctive competitive advantage in the distribution area. However, that isn't the only place. Other sources of competitive advantage for many companies include operational efficiency, particular service capabilities, high-level underwriting expertise and diversity of product and geography.

The next area of our analysis is a company's operating results or operating earnings. What we're looking at here is a company's earnings on a risk-adjusted basis and relating that to peers and to the risks that they have embedded in their products and their strategy. We use a number of different tools for that. Typically for most life insurance products we're looking at return-on-assets-based measures. For some products, such as term insurance or health products, that are not asset-intensive, we're looking usually at a return-on-revenue basis with some benchmarks that are meant to adjust for the risk inherent in different products. We're looking at both the underwriting performance and the investment performance in this evaluation, as well as companies' expense efficiency and benchmarking in those areas. The sorts of benchmarks that we set for companies are going to depend a lot on the risk profile and on the level of volatility. For a company in a volatile line of business, such as property catastrophe reinsurance, we're going to have a pretty high benchmark that we expect them to meet because we know that results are going to be up and down over time. For a company in participating life insurance, obviously that's a very stable area, so the benchmark may not be as high, to reflect the lower risk of that product profile.

Capitalization is also an important area of our analysis, but it's not as simple as just a risk-based capital ratio. A lot more goes into it, including both quantitative and qualitative measures that we use. S&P uses a capital adequacy model that we've developed internally. It's a lot like the NAIC's RBC model, but it has some differences associated with it, in part to capture some risks that we feel are not appropriately captured in the NAIC's model and also in part because the purpose of the models is a bit different. The NAIC's model is meant to set a benchmark for solvency essentially. Our model is differentiating between investment-grade and non-investment-grade companies—those that are likely to maintain financial strength and those that are less likely to—and then to form gradations above that in terms of the level of strength of different companies. There are different motives in the models, so definitely the benchmarking is a bit different.

But outside of that pure risk-based capital figure, there are other areas that are very important to the analysis of a company's capitalization. Included in that is a view on the financial leverage in the group, looking not only at the insurance company, which may have debt or surplus notes, but also at the broader holding company structure, if a company has one.

Outside of that, qualitative measures that we also look at it include looking at the composition of a company's capital structure. How much is equity? How much is debt? How much is preferred stock or other sorts of hybrid securities? Obviously the preference is for the more permanent types of capital, equity capital. The other types of capital are certainly acceptable in a company's capital structure, but with some limits. We're always going to favor a capital structure with more equity than one with less, particularly when you get to the point of very high levels of financial leverage. We also look at the ability of a company to organically fund their capital need. It's not just the level of your capital adequacy today, but what are the trends? Are you earning enough money on a statutory basis to continue to feed your capital need going forward, or are you growing so quickly that you're eating through capital? That's a very important element of the analysis. What is your reliance on reinsurance? We certainly don't think that reinsurance is a bad thing, but to the extent that companies are overly reliant on financial reinsurance (for example, to support their capital structure), that's a bit less favorable than a company that isn't necessarily needing to rely on those areas to support the capitalization.

Investments, obviously, are a very important area. We look at a number of issues here, including the quality of a company's portfolio, particularly credit quality. We look at interest rate risk management. That includes looking at things like duration and convexity matching as a starting point, but we also look at a company's stochastic modeling of their interest rate risk and at a company's processes and procedures and how they actually manage interest rate risk, particularly if they have portfolios that are heavily concentrated in spread-based products, such as GICs, funding agreements, fixed annuities, etc. Investments are an area that's had a great deal of emphasis from us recently.

Liquidity is a very important area at which we look very closely. I think that in general the industry is in a better position today than a few years back with some of the options that had been built into products, but it's still an area of strong importance, especially with the growth that some companies have had in their fixed annuity books and questions about how that may perform going forward. We have constructed a model that looks at a company's availability of marketable assets and compares that to the potential liability need in a stress scenario. We look at it two different ways. One is sort of a 30-day "run-on-the-bank" scenario. If you had a huge surge of surrenders, how quickly could you liquidate assets to get out of that situation? The second is sort of a one-year "slow-bleed" scenario. On that longer-term scenario, you should be able to liquidate more of your assets at a higher price over the longer period of time, but also in those sorts of scenarios you're going to have more of your liabilities called in over the longer time period. We look at both of those types of bases to understand a company's liquidity profile.

The final category of analysis is financial flexibility. What are a company's financial needs relative to their access to capital to support them? What is a company's access to the debt or equity markets? What is a company's access to resources of affiliates? It's nice to have a rich European parent sometimes, particularly when assets are defaulting and after all the horrible things that happened in the markets the last couple of years. We also look at access to reinsurance. It may have sounded like I disparaged financial reinsurance a few minutes ago, but that is a potential useful source of capital for companies that may find themselves in need. We will look closely at a company's access to reinsurance, or have they already reinsured so much of their book that they're tapped out in terms of their access to those markets?

All of those items boil together to make a rating. People often ask us which categories are more important and which ones are less important. The answer is that it varies. It depends on a company's particular situation. For a mutual company that has 800 percent risk-based capital, capital is not the most important part of the analysis by any means. For a young, high-growth company with a wonderful strategy but maybe not the capital to support it, then capital and financial flexibility become huge components of the analysis. It really depends on where the pressure points are with respect to a given company's situation as to how these points weigh together to come to the final conclusion of a rating on a company's financial security.

I'd like to lay out some of the strengths of the U.S. life industry, as we view them, and relate them back to those categories that I just talked through. There is strong and recovering capitalization. The industry is generally quite well capitalized, having recovered well from the declines in capital that we saw through 2002 and 2003, the bear market effect. Favorable long-term demographic trends will make a contribution to the industry's competitive position, particularly in terms of aging population and concerns about the Social Security and pension systems, potentially leading to a lot of attractiveness in the long term toward retirement savings products in which the industry has specialized expertise. We've seen improving operational efficiencies through the use of technology, particularly the mutuals and the demutualizing companies over the last few years. We've seen expense ratios coming down and better efficiency affecting earnings. That's a good thing, particularly as other things have strained earnings the last couple of years, such as lower spreads and so forth.

There are benign credit trends. Looking at corporate bond default rates, which were at record-high levels in 2002 and for several years leading into 2002, rates of default on corporate bonds this year are expected to be well below historical averages. It's not going to stay that way forever, but at least for now we expect default activity to be good. Last, lessons were learned from past economic stresses. This most recent stress has taught companies the importance of hedging equity market risk that's built into your products, for example. Economic stresses from the early 1990s taught companies that large concentrations in real estate are not a good thing. In many ways the industry is better positioned today because of some of these lessons learned from these past stresses.

Despite those strengths, we do see a number of challenges that the industry faces. Credit spreads are tight. The interest rate outlook is uncertain; the industry doesn't know exactly where rates are going to go going forward. Currently the equity markets are relatively flat. Increasing product risk is coming from a number of areas. Combined with that increasing product risk, because of the consolidation among reinsurers, there is less ability than there once was to lay off that product risk on the reinsurance community. Finally, the increasing regulatory burden is of special importance the last couple of weeks.

The chart (see Clark page 8, slide 2) shows what the industry's investment yields have done over the last four years. What's interesting is that I think there's a lot more pessimism now about the direction of the economy than there was several months ago. Despite the fact that the Federal Reserve has begun increasing short-term rates, the 10-year Treasury has continued to come down and has been hovering for a while now around the 4 percent level. As long as the Treasury stays that low, we're going to see that yield figure plateau, if not even come down a little bit further, as higher-yielding, older assets roll off and are reinvested at lower interest rates.

The next chart (see Clark page 9, slide 1) shows the movement in corporate bond spreads over the last several years. You can see that there has been a dramatic drop from the peak in the most pessimistic part of the cycle to where bond spreads are today. Investment-grade bonds earn less than 100 basis points above Treasuries today. That makes it very difficult for insurance companies to earn money on their investment portfolios, and, in some cases, it induces companies to do higher-risk things in their investing to enhance their yields.

We do expect interest rates to rise, obviously, but the pace of it is completely uncertain at this point in time. I think that anybody who looked ahead six to nine months ago would have thought we'd be far ahead of 4 percent on the 10-year Treasury today, but we're not. There has been a lot of uncertainty there. In the near term, there's going to be continued pressure on companies' spread income because of that low level of interest rates. Longer term, we should see some relief from that if we do see a gradual rise in interest rates, but there is a concern as to how well the industry may be positioned to absorb a sharp rise in interest rates should they rise more quickly than expected. It's going to cause pressure on annuity surrender rates if that occurs, and it remains to be seen how the industry will react to that. Companies may let their spreads get tightened on the way up to keep the money in-house as opposed to seeing a bunch of net outflows on their annuity products. Some companies have extended out in asset duration, creating intentional duration mismatch between assets and liabilities in their portfolio, going out longer on the yield curve to enhance yield. That's a fairly high-risk strategy and could put companies in a very bad situation if rates do rise rapidly. It's something to which we're paying very close attention and just underscores the fact that ALM is extraordinarily important in a time like this, where the future direction of interest rates is very uncertain.

We see product risk on the rise. In the variable annuity area, a number of new benefit types have been coming on in recent years, particularly guaranteed minimum accumulation benefits (GMABs) and withdrawal benefits (GMWBs). Those types of benefits are driving most of the sales growth that we see in the market today. Some companies are pricing those benefits appropriately and hedging the benefits appropriately. Others are not. Guess which ones we're concerned about. There is universal concern that even if companies are attempting to manage these risks prudently, there's a lot that you don't know about what policyholder utilization is going to be on these newer benefit types, so it's a guessing game to hedge these risks completely.

The other area of some concern is universal life products with secondary or no-lapse guarantees. Pricing is perceived as being quite aggressive, particularly among some of the leaders in that area. Companies are doing a lot of creative things to avoid holding the Guideline AXXX reserves. There's a lot of suspicion that these rates are not supportive of the long-term risk of the products. We know that companies are making assumptions in their pricing about future improvement in mortality and about future rises in interest rates. If those assumptions don't come true, then there may be risk here, not to mention that some of the lapse assumptions in the pricing of these products are suspect. There is almost no reinsurance market for either of these two product risk areas, so the life companies that are writing these risks are stuck with the risks and may have some headaches many years down the road, relative to the risks that they've taken on.

Lest you forget your old variable annuities that you wrote several years ago, we know that the industry wasn't adequately pricing variable annuity guarantees in the past, nor were they adequately hedging the risks. Those risks haven't gone away, despite the fact that we had good equity performance in 2003. If you wrote a guaranteed minimum death benefit with a 5 percent roll-up at the top of the market back in early 2000, and that death benefit guarantee has been increasing at 5 percent ever since while the equity markets are kind of stagnating right now, the flat-lining equity markets that we're seeing today are not taking the error out of that in-the-money benefit. There's a lot of continuing concern about the long-term buildup of reserves and liability under those areas.

I'm going to talk very quickly on regulatory risk. All of you know the challenges that you faced in these various areas recently in terms of various new accounting standards, some of which add transparency and some of which actually make my job a lot more difficult in terms of added complexity in the financial reports. They have added complexity to company actuaries' lives as well, in trying to comply with the barrage of new requirements that have come on from different accounting standards recently. Tax is an area that the industry has long considered to be an advantage in that the industry's products are taxed advantageously compared to other investment-type products, but that's an area that we think is going to be under a long-term assault. The area of regulatory oversight is seeing hugely increased activity from the SEC and from the National Association of Securities Dealers. Need I mention Mr. Spitzer, New York's attorney general, in terms of scrutiny of the industry in various areas? I'll give you the two-minute version of our view on what's going on with the New York attorney general's current investigations of brokers and the charges that have been made about bid-rigging and contingent commissions.

From what we know about what's going on with that investigation and particularly in the life insurance industry, it seems that most of the subpoenas in the life-and-health area so far have been concentrated on group employee benefits providers. It hasn't filtered down, at least not yet, in any significant way to the individual life side of things. We know that almost every company who's a major player in the group-life-and-health-and-disability area has received subpoenas from the New York attorney general. What's he going to find? We don't know. We certainly don't have any evidence of bid-rigging as Marsh has been accused of, but you can't rule out the possibility. We do know that contingent commissions do exist in that area, and there may be issues where companies or brokers need to repay profits from those fees or pay fines. In our view right now, it doesn't seem that the level of liability relative to these things in the life insurance sector is going to add up to anything that's going to be a material financial impact for the industry, at least not for most companies. However, it's too early to tell, and it's too early to know the extent to which these areas are going to evolve.

One thing that we do know out of these investigations, though, is it seems that some practices that the industry does in terms of distributing its products are not illegal, but perhaps misalign the motives of the distributor of the product and the end consumer, such as bonuses and other sales inducements. Those types of arrangements are coming under fire, and the industry is going to have a lot of challenges to face on an ongoing basis and may have to redefine a lot of the ways that we distribute products going forward. It's going to be an interesting evolution, I think, as we see this bear itself out.

MR. ROBERT L. RIEGEL: I'm happy to have the opportunity to share Moody's current views with the audience today. I'm first going to tackle the question about Moody's views on the industry, and then the second part of my presentation is going to be on our rating methodology. I'll try to move through this relatively quickly and focus on the issues that are different. Moody's has a different view than S&P.

As far as where we are today in terms of the industry, our average financial strength rating is currently A1. The average senior unsecured debt rating of the holding company is Baa1. Life insurance companies are rated somewhat lower than other financial institutions at Moody's. We've had a stable outlook on the industry since the second quarter of 2004. We changed the outlook from negative to stable because of the improved environment. The economy, although not rebounding strongly, has stabilized equity markets from 2001 and 2002. Interest rates, although holding pretty steady, are more likely to go up than down.

Regarding the distribution of our ratings, we have just under 80 life insurance groups, heavily centered around low Aa and A ratings. We looked at rating upgrades and downgrades over the past 10 years. Downgrades in 2002 and 2003 exceeded upgrades by a ratio of about three or four to one. During most of the late 1990s and early 2000s, upgrades exceeded downgrades, primarily driven by merger and acquisition activity. So far in 2004 there's a roughly equal number of upgrades and downgrades. Again, the average financial strength rating is currently at A1 for the industry, trending down over the past 10 years from Aa3.

I'd like to give some financial metrics for the industry. The industry has about $500 billion of statutory premiums, split roughly two-thirds between annuity products and one-third protection products. We expect the mix to continue to emphasize savings and investment products going forward. Demand for protection products has continued to decline over the past 10 years. If we look at assets for the industry, there is $3.4 trillion, split roughly as two-thirds general account and one-third separate account. The compound annual growth rate for the separate account is a hefty 15 percent over the past 10 years and for the general account is 6.5 percent—pretty slow and steady.

If we look at profitability metrics for the industry, there's a lot of volatility here, partially driven by the economics of the business and partially by the accounting requirements. Statutory return on average total assets has been bouncing around between 60 and 80 basis points. Looking at statutory return on capital, again you can see a lot of volatility, but it's roughly in the 8 to 10 percent range over the past 10 years. If you look at asset composition, you can see roughly 75 percent of the invested assets is in bonds. Of the bond portfolio, roughly 75 percent is in public bonds, and 25 percent is in private placements. The big shift for the industry over the past 10 years has been the reduction in the mortgage and real estate asset class.

Rodney talked about the declining investment yield. Over the past 13 years, the net investment yields dropped by about 300 basis points. However, compared to current interest rates and new money rates for alternative products, the portfolio yield is still attractive. Underperforming mortgages as a percentage of statutory assets continue to get better. We do expect delinquent mortgages and underperforming mortgages to increase this year and into next year as we see some softening in certain real estate markets for certain real estate property types. Low investment-grade bonds as a percentage of invested assets jumped up in 2002 to hit 6.6 percent of invested assets and is down to the more historic norm of about 6 percent.

The capitalization ratio declined in 2002 and recovered in 2003 and so far, year-to-date, in 2004. The NAIC risk-based capital ratio is quite high at over 350 percent at year-end 2003. Our view is that the industry is reasonably well capitalized today, although there are some concerns looking out in the future. Looking at financial leverage, the industry usually maintains debt to capital in the 20 to 25 percent range.

Let's talk about the core strengths of the industry. We do believe that it's adequately capitalized and that there's modest use of debt in the capital structure. The in-force business is going to throw off embedded earnings over the next 10, 20 and 30 years. The industry is somewhat unique in that it does not need to sell new business. The in-force business is very stable and predictable and will throw off earnings. Another strength is the investment portfolio. The industry fared well through probably the worst credit down cycle, 2001–2002. The investment portfolio is well diversified, and the credit losses were manageable. The industry for the most part has strong liquidity. Perhaps the most important competitive advantage for the industry is the ability to offer tax-advantaged products compared to other financial institutions.

There are some weaknesses in the industry. There is movement away from the traditional strengths, which include mortality risk underwriting, persistency and asset/liability management risk. The industry is moving toward equity-based products, which have not been its core strength. There is weak earnings capacity relative to other financial institutions. Whether you're looking at return on assets or return on capital, this is primarily driven by the very high distribution costs that the industry faces. There is concern over the increasing risky contract options and guarantees in the products. Rodney talked about secondary guarantees in variable annuities and no-lapse guaranteed universal life products. Another point is the continual threat and erosion of the tax-advantaged nature of life insurance products. A big blow for the industry would be if Washington did something very significant in terms of weakening that tax advantage.

I'd like to mention some characteristics of the life insurance products and markets. We see modest demand for most protection products. Most of the growth has been in the investment and savings products. We see it being very difficult for companies to establish sustainable competitive advantages. Most of the products are very commodity-like, competitively priced and low-margined. The whole issue with XXX and AXXX statutory reserve requirements is a big issue for the industry. We estimate that there is about $100 billion of reserve requirements that the industry is going to have to fund over the next five years. The industry is primarily relying on letters of credit from banks, but some companies in the last year and a half are focused on funded trust structures, which we think are prudent and appropriate to manage the collateral requirements on the statutory reserves.

Then there's the issue about mutual funds and variable annuity market-timing allegations. As Rodney said, it's too early to tell about the whole issue with Spitzer and the brokers, but the employee benefit market does have all the ingredients for possible wrongdoing, just like the commercial insurance and the brokers. We're waiting to see what falls out of that. I find it interesting that Spitzer was also talking about bringing it down to the retail level.

Is capital adequate? The industry is well capitalized today, but there are a lot of issues out on the horizon that make us question whether it will remain adequately capitalized. We see continued general account growth with the institutional spread business and the XXX and AXXX statutory reserve requirements totaling $100 billion. The C-3 Phase 2 reserve and capital requirements, which look like they're going to come into effect year-end 2005, are a big question mark. We don't know what that's going to do to the balance sheet and capital adequacy for the industry at this time. Clearly with rising interest rates you have the potential for unrealized losses on the bond portfolio. As we saw in 2001 and 2002, if we do get another economic downturn and credit losses either in the bond portfolio or in the real estate portfolio, the industry does not make a lot of money. The credit losses wipe out earnings quickly and start eating into capital, as we saw in 2001 and 2002.

In conclusion, our outlook for the industry is stable. We see greater industry risks today and greater optionality. We believe the industry will remain highly rated, in the A-rating level, but lower than it was 10 years ago.

I'll spend five minutes on our rating methodology. There are a couple of key objectives in our methodology. We try to have a globally consistent framework for assessing credit risk. Whether we're looking at companies in different industries or insurance companies in different countries, we try to make sure our ratings are comparable. Our rating horizon is three to five years. That's about as far as we can look out. Companies change pretty significantly in a time period longer than three to five years. We do have rating outlooks on all our ratings that cover a 12-to-18-month time horizon. Our ratings are forward-looking perspectives in terms of the ability of companies to meet their obligations, whether they're insurance obligations or debt obligations. Some of these liabilities are very long-tailed, so we are trying to be as prospective as possible.

Unlike Eric's view, credit analysts and rating agencies are downside-oriented. There's not much upside potential on an insurance policy or a bond. You get what you're promised. Therefore, we tend to look at what can go wrong at companies and what potential losses there are to bond creditors or to policyholders. Our approach incorporates both qualitative and quantitative analysis. Each rating is issuer-specific; we don't have a road map or guidelines to rating categories.

In terms of our quantitative analysis, about two years ago Moody's implemented what it calls "Enhanced Analysis Initiative." The objective is to improve the accuracy, stability and transparency of our ratings. In our write-ups, we now are providing explicit financial metric expectations for the current rating level and drivers of the rating—what could move the rating up, what could move it down. We're trying to be as explicit as possible. The key metrics are specific to each company, depending on the particular business the company is in, and these are discussed and determined by rating committee. Obviously these metrics might not play out if something unexpected happens with the company in terms of a merger/acquisition deal or some significant change in the external environment.

Moody's has been increasing the use of their quantitative tools over the past couple of years. We look at market-implied ratings. We look at bond yields. We have a big database that gives ratings based on option-adjusted spreads on bond pricing. We look at credit default swap ratings and ratio-implied ratings. We look at the ratings that our competitors have on companies. We do a lot of trend analysis and comparative peer company analysis, both statutory and GAAP. We've developed our top 10 quantitative ratios for life companies. We've developed rating models: rating predictor models, default predictor models and rating models based on our top 10 ratios. We introduced a liquidity model two years ago, and we're currently working on a life insurance capital model.

The quantitative tools are used extensively at Moody's in various ways. The analysts use these quantitative tools to monitor their companies on a more real-time, live basis. We do portfolio reviews once a year for every industry sector, and the quantitative tools are used to identify outliers, based on means and medians for rating categories. All of these quantitative tools are presented in rating committees now.

I'd like to talk about our top 10 ratios. The key areas that they cover are the business fundamentals (the size of the company and the mix of the company's business), capital adequacy and volatility, profitability, financial leverage, interest coverage, cash-flow coverage and liquidity.

I'll go through the top 10 ratios quickly. Market presence is basically the size of the company. We do feel there are economies of scale in this industry. The market presence ratio takes the log of the company's surplus relative to the log of the industry's surplus. It correlates very well with our ratings. We take the log because we think there is a diminishing return of too much capital. It is a key driver of our rating.

The second ratio is mix of business. This looks at individual life insurance premium as a percentage of total premiums and deposits. The more individual life business a company has, the higher it is rated. That's because we like individual life business, particularly the participating whole life business, which we feel provides companies a lot of flexibility with the dividend mechanism.

The third ratio is capital adequacy. Until we fully implement and roll out our own new-and-improved capital model, we are looking to the NAIC risk-based capital ratio. There's a decent correlation with this ratio and our ratings. The fourth ratio is capital growth and volatility. This is a Sharpe ratio of statutory capital growth. It's looking over the past five years, and it takes the mean of the one-year statutory capital growth divided by the standard deviation of the one-year statutory capital growth for the past five years. There's actually a strong correlation with our ratings.

The fifth ratio is profitability. This is a statutory-return-on-capital measure. We take pretax, pre-policyholder dividend operating income divided by statutory capital. We take pre-policyholder dividend because, as I said before, the participating whole life business affords the company a lot of flexibility. It can reduce the policyholder dividends if investment experience or mortality experience is much worse than expected. This is our measure of operating profitability that tries to get at the flexibility associated with a company's liabilities. The sixth ratio, profitability-expense efficiencies, is just total statutory expenses divided by total assets. Except for the non-investment-grade ratings, you could see a good correlation with ratings.

The seventh ratio is financial leverage. This is debt divided by total capital. This is a GAAP ratio. Lower-rated companies have higher financial leverage, although it's not a significant difference. The eighth ratio is interest coverage ratio. This is GAAP earnings before interest and taxes divided by interest expense. There's a good correlation, again, with our ratings.

The ninth ratio is cash-flow coverage. This is the holding company analysis. We take the maximum statutory dividend capacity, whether it's the greater of 10 percent of statutory surplus or last year's operating earnings, and divide it by interest expense. The final ratio is our liquidity ratio, which is liquid assets divided by liquid liabilities.

That should give you an idea of some of the key ratios at which we look. We are trying to continue to improve being more transparent in our analysis, both with issuers and with the investor community. Moody's will always have a combination of quantitative and qualitative analysis, but clearly over the last couple of years and going forward we expect that the use of quantitative tools will continue to increase.

MR. ERIC BERG: I'm the life insurance analyst at Lehman Brothers. For those of you who don't know what that means, on the equity side it means that I'm responsible for our firm's analysis of and commentary on publicly traded life insurance stock. My world is companies like MetLife, Hartford, Nationwide (at least on the life side), AIG (on the life side), Prudential, AFLAC and other big, publicly traded life insurance companies. To put it even more simply, some people have said that fixed-income analysis, or the work that Rodney and Robert do, is basically a matter of answering the question, "Will I get paid, and, if so, when?" What we try to do is answer the question along the way, "How good will it be?"

I'm going to give my presentation in three parts. First, I'll give you a summary statement as to what we at Lehman Brothers are saying in general about the life insurance business. I'll then give you what I call a "skate around the pond." By that I mean I will be synopsizing for you our most recent work on the life insurance industry, essentially excerpting some of the research that we think is our better work. Then, third and finally, I'm going to talk to you about an issue that is near and dear to my heart as a CPA with a particular interest in financial reporting by financial institutions. I'll be talking to you about current and emerging accounting issues and what we at Lehman have to say about them.

What are we saying about the life insurance industry? I can be pretty succinct. I just want to echo what Robert and Rodney had to say. The business is much more complex and much more challenging than it has ever been. I think it's fair to say that the life insurance business today would probably be unrecognizable to executives who were in the prime of their career, say, 25 years ago. It doesn't make a difference whether we're talking about the asset side of the balance sheet, the liability section of the balance sheet or the equity section. It truly is, as Robert and Rodney said, a new world, whether it is on the liability side—the guaranteed minimum income benefits (GMIBs), the GMABs and so forth; or on the asset side where the last, say, 10 to 15 years have seen the proliferation of myriad new asset classes, whether it's commercial mortgage-backed securities, residential mortgage-backed securities, aircraft-related assets such as equipment trust certificates and enhanced equipment trust certificates; or on the equity side, where we've seen the development, the debut, of, again, new types of equity securities: trust preferreds and combination securities that require a person to buy debt but at the same time agree down the road under a so-called "purchase agreement" to convert that debt into equity.

It's a whole new world for life insurance companies today. The life insurance industry and, therefore, life insurance stocks shouldn't be thought of as the defensive, conservative investments they once were. If a lot of life insurance executives are sitting straight-up in the middle of the night sweating, feeling very disoriented and wondering what's going on in the world, it is understandable. My message would be to you and to investors that their world has changed profoundly in the eight years that I have been following this sector. It makes investing in this sector as an equity investor much more challenging and much more perilous than ever before.

I'm going to dive into a sampling of some of our research that attempts to talk about some of the issues that have been on our mind. I have an excerpt from a study we did on the issue of interest rate risk in the disability business (see Berg slide 3). Our interest in interest rate risk was peaked in 2004's March quarter, I believe it was, when Unum announced a very substantial increase in its reserves with a reduction in earnings and a reduction in book value as a result of its inability to earn as much as it had expected to earn on its investment portfolio. In short, Unum lowered its discount rate. We wanted to answer the question, "Who's next?" What other insurance company might have to lower its discount rate, charging earnings, producing an earnings disappointment and surprising investors with lower-than-expected earnings?

It turns out that answering that question is not nearly as straightforward as one would hope. Companies don't disclose much about their interest rates underlying their disability reserves. They typically disclose one rate only, which can be called a blended discount rate. What I've written here is something we feel very strongly, which is that few, if any, solid inferences can be drawn from these blended rates. The reason should be quickly apparent. An insurance company should be able to use a high discount rate if, in fact, it wrote lots of disability business many years ago when interest rates were higher. To say that one company has a higher discount rate than another and is, therefore, more aggressive than the second company is not fair because it doesn't take into consideration when the business was written and what interest rates were when that business was written.

What's needed is a common yardstick. Hopefully what we did in terms of a contribution in this piece of research is to develop that common yardstick, a way of placing, as I've written here, all the companies on the same common footing. The yardstick that we came up with is essentially to try to calculate the spread to Treasuries that different disability companies have been using in setting their discount rates. Due to our time constraints, I need to skip all the methodology, but I'd be pleased to go through it with you privately. It is kind of involved. The point here is that we were able to calculate, using a series of steps, the spread to Treasury that we believe each company has been using to set its disability reserves.

That's actually contained in the first shaded column on the left, column A. Essentially what we did here, to cut right to the quick, is to answer the question, "Supposing each company adjusted its discount rate to bring the discount rate in line with the industry mean: what would be the impact on reserves and on earnings both in dollar terms and in percentage terms?" Who, in short, is most at risk of surprising investors negatively by having to cut their discount rate? The answer, to our surprise, is that there seem to be some issues at Hartford and StanCorp. Our conclusion is that both of these companies have discount rates that are materially above the industry average and that if they were to cut their discount rate to bring that rate in line with the average, there would be a material impact on the earnings of Hartford and StanCorp.

By the way, in the course of this presentation, I will be making comments about specific companies and, quite frankly, taking some shots at them. I will try to be as balanced and as fair as I can in the sense that I will share with you what they had to say in response. When I was a working journalist, I was a reporter and editor for several years at *The New York Times*. We always made it a practice to include in the newspaper what individuals or institutions had to say about critical articles. We do the same thing in our research at Lehman. If we're taking a shot at a particular company, we will always include a company response. If I fail to do that today, it is in the interest of time, and I'll ask you to refer to the specific research so that you can see in detail a company's response to our research.

Now I'd like to talk about another issue that Robert and Rodney referenced. It has to do with the whole issue of interest rate risk (see Berg slide 4). Here we were trying to answer the question, "Which insurance companies' earnings are most at risk of a disappointment owing to higher than expected turnover in their investment portfolios relating to bond calls, bond sales at a gain and unexpected prepayments on mortgage-backed securities?" It turns out that if you go into the statutory statements, the so-called "blue books," you can get a very good sense of what the normal turnover is in a company's investment portfolio and, therefore, what is unusual turnover. If you look in the investment exhibit and you look at what average turnover has been over the last five years, and then you compare that average to what happened in 2003, you can see that there was a tremendous amount, for many companies, of excess turnover. That is, methodologically speaking, what we did.

We calculated for every one of the companies that we follow, our so-called "coverage universe," the average turnover of their investment portfolio for the five years preceding 2003, and then we compared that turnover rate to the turnover that occurred in the portfolio last year, in 2003. We classified the excess as "unexpected turnover," and we used as a simplifying assumption the idea that any excess turnover was unexpected and would have to be reinvested at today's current low interest rates. Who would be hit the hardest? Again, I think you're going to get a sense through our research here that over and over again on the equity side we're really interested in answering the question, "Who's most at risk?" Who could get hit the hardest? Who's best positioned to benefit?

The long and short of things from this piece of research is that we think that there are prepayment issues coming for the remainder of this year and next year at MetLife, Protective Life and Jefferson Pilot. I'll refer you to column G, where we give in percentage form the expected impact on their earnings of the unexpected prepayments. The way to interpret the numbers is essentially that this is by how much lower earnings will be than they would have been had these companies not had the unexpected prepayments.

The next issue is one that has been discussed greatly in the actuarial community. It's one that, once again, we try to dig into by naming names and identifying those companies that we think may have issues. The XXX issue essentially is one that both Moody's and S&P—indeed, all the rating agencies—have written about extensively. It is that the reserves will be rising rapidly, and that in response to growing XXX requirements, companies have been using letters of credit to collateralize offshore arrangements with reinsurers to sidestep XXX. Consequently, there are not going to be enough letters of credit to meet the demand for them or, at a minimum, earnings are at risk because the demand for letters of credit will surge.

I have a list of companies that, in our judgment, have considerable exposure to this issue (see Berg slide 5). By way of telling what some of the companies had to say, in the case of both RGA and Protective, two companies we highlight here, both of these companies pointed out that they are working on capital market solutions to deal with the XXX issue (and there have been some capital market solutions), but also that in the case of RGA, an important part of its seeming letter-of-credit exposure in fact relates to financial reinsurance transactions that do not attract the same XXX reserves that you might think if these were, say, transactions involving normal life reinsurance. I wanted to provide that caveat.

There's another question we addressed that got lots of attention. It's a look at the whole issue of which annuity company is best positioned to gain market share in coming quarters because it has the best lineup of mutual funds. Allow me to explain. It seems to me that there's no shortage of information out there about individual mutual funds. You can look it up in the library in *Morningstar*. More easily, you can go online. There are lots of rating services that track the performance of individual mutual funds, and there are rating services that track the performance of mutual funds inside variable annuities. Of course, the performance of a mutual fund inside an annuity is typically not as strong as that performance is outside the annuity, because of the presence of additional fees inside the annuity.

Try answering the question, however, of which annuity company has the best mutual fund lineup overall. Our thesis was that with the industry essentially having copied one another, with industry participants having spent the last year and a half copying one another's guarantees and with everyone essentially at this point offering the same things with the same distribution channels and pursuing the same customers, it's back to performance. Whichever annuity complex has the best lineup of mutual funds overall will have the best marketing story to tell, the best performance story to tell, and will get the business.

Again, there's no time to go through the methodology. We can, again, speak privately about it. Suffice it to say that there are big differences among the annuity companies (see Berg slide 6). Some, such as AIG, which of course owns Sun America, Lincoln, Hartford and Nationwide, have lots of four- and five-star mutual funds. As well, these companies tend to have funds that span a broad array of investment categories—growth and income, domestic and international, value and so forth. There are other companies by comparison, like Prudential, just to give one illustration that I choose entirely arbitrarily, that don't have a lot of five-star funds and don't have a lot of breadth. The purpose of this research is essentially to say that there are some companies that will be better positioned than others to compete.

A study that I found absolutely fascinating is about a business that a lot of people don't know about but that has been growing extremely rapidly, literally out of nowhere, at Hartford, their mutual fund business. Everyone knows that Hartford has a very successful, nonqualified variable annuity business. But did you know that Hartford has a garden-variety, plain-vanilla mutual fund business that competes against everyone else's, including Putnam's, MFS's and Fidelity's? Did you know that in the short span of about seven years Hartford has built this business from scratch to about $25 billion in assets under management?

We became fascinated with this issue at Lehman Brothers. We wanted to answer the question, "What's going on here?" Why has Hartford been able to grow this business as quickly as it has been, and, most importantly, how sustainable has the growth been? Let me give you the punch line. We think the growth is sustainable. The reason we think the growth is sustainable is that this analysis demonstrates quantitatively that the cash flow into The Hartford mutual funds has been significantly better than the cash flow into competing funds of like style and of like performance.

We looked at the cash flow coming in, the net flows coming into Hartford funds, and compared that cash flow to the cash flow of similarly situated funds with the same style and the same performance. We controlled for those two factors. What we found, to summarize, is that Hartford's cash flow handily exceeded that of competitors. The point is that it must be the case that Hartford has been a much better marketer of its mutual funds than its competitors. It has been a much better teller of its performance story than competitors have been of theirs.

I'll make one quick comment about this long-term-care business. We don't know what to think about long-term-care insurance, quite frankly. Many of our companies are in the business—Unum, Manulife's John Hancock subsidiary and Genworth—could not be more excited about it. All I have to say is, if it's such a good business, why is everybody getting out?

I'd like to point out the extraordinary power and success of the GMWB. I agree entirely with Robert and Rodney that it is the case that the variable annuity business has undergone a transition away from tax benefits and toward guarantees. This has changed the game in a way that I tried to allude to at the beginning, by shifting risk back to the insurance companies, increasing the risk from investors' point of view and increasing once again the importance of ratings. Look at what happens to sales when companies begin offering no-lapse guarantees (see Berg slide 9). We, too, on the equity side are fascinated with this issue. We've begun a project aimed at reverse-engineering real-life contracts out there and attempting to answer the question, "Who's making aggressive guarantees that underlie their universal life secondary guarantees with respect to investment returns in the future and persistency?"

MR. MAX J. RUDOLPH: I have a question for the two individuals from the rating agencies. In the liquidity scenario, the 30-day run on the bank, it makes an assumption as to how quickly you can sell the assets and at what rate. It seems to come back to that it's not a run on the bank just for your company, but it's a run on the bank for the entire market. Could you talk about how far out in the tail you are assuming, and is that consistent across capital and your other tests?

MR. RIEGEL: I'll say a couple of things and then pass it on to Rodney. Moody's liquidity model is actually driven off of the statutory data from the blue book, and the disclosure in the blue book is very limited. In terms of transparency and disclosure of risks, you're starting with a handicap. We recognize the limitation of our liquidity model. We've said that it's an initial screening for identifying companies that could be subject to a potential liquidity squeeze. We look at the liabilities, we look at three time horizons—one month, six months and 12 months. We have a factor as to how much of the liabilities (again, based on the blue book's disclosure) could run over those three time periods, then we haircut the assets and come up with liquidity ratios for the three time horizons. That's the starting point. Then we sit down with companies and go over their analysis in terms of a potential liquidity squeeze. In that case we view it more as a company-specific liquidity crisis. In the past we've seen company-specific loss of confidence and run-on-the-bank scenarios. We ask the company how it looks at liquidity. We walk through the assumptions and usually have a thorough discussion with the company. That's our approach to liquidity. We recognize the limitations with our model, but it's the discussions with companies that add substance to the model.

MR. CLARK: Max, I can't really answer the question as to how far out in the tail we are looking with the way we do the liquidity model. What I will say is that a run-on-the-bank scenario is an extreme situation. It is a tail-type scenario in any event. We are definitely looking at a scenario that we think is extreme and unlikely, but we are trying to understand how well our company is cushioned against the extreme, unlikely and unexpected scenario. There is a presumption built into the way we look at assets in the liquidity model that you can't get the full market value, in part, because there may be some contagion. There may be some sort of industry-wide reputational damage that causes maybe not a run on the bank for everyone, but at least some pressured selling across the industry, which will cause some depression in the values that you're able to receive for various assets, particularly less liquid forms, such as commercial mortgages, commercial mortgage-backed securities and so forth, for which our model is pretty punitive. We're going through a reevaluation right now. We're looking at bid-ask spreads and market price volatility on different classes of assets and looking at refining what that is, but there is an extent to which the liquidity modeling is meant to determine what's going to happen in an unlikely but scary scenario and which companies are better positioned than others to respond to that. To some extent, looking at existing evaluations in the market doesn't help you get there very well because what we're trying to capture is the unexpected or extreme scenarios. We are looking to fine-tune the quantitative aspects of how we look at assets in that modeling.

MR. HUBERT MUELLER: My question is for all three panelists. With regard to capital adequacy, to what extent and when will you include and utilize the C-3 Phase 2 modeling for the variable annuity business? It's likely only effective the end of 2005. Will you start looking at those kinds of results even before the end of 2004, and how will you integrate those results into your views of capital adequacy?

MR. CLARK: From our perspective, we're already talking to companies about their early modeling and what the impact is going to be. A few companies are going to be sharing some scenarios with us early so that we can understand the impact of the C-3 Phase 2 modeling. We haven't determined what our final approach is going to be, but it's very likely that our capital adequacy assessment is going to either use the NAIC's approach or use something very close to it that can build off of the very same modeling. I think it would be wonderful if we could implement something involving that for 2004 year-end, but I think the reality is that a lot of the companies that we rate are not going to be equipped to do that yet at 2004 year-end. We're looking at what we can get and trying to assess the impact. Definitely we'll be folding it in beginning in 2005 at some point. As we fine-tune where the methodology is going to go, we'll be communicating that to the market.

MR. BERG: The answer to your question is that we care a lot right now. The reason is that return on GAAP equity is a major measure and major way of evaluating companies and a major driver of value of the price of the stock. While C-3 Phase 2 nominally is a statutory thing, it does affect GAAP equity because it's my understanding that additional statutory capital on reserves under C-3 Phase 2 will appear as equity under GAAP. There is, therefore, the real potential, barring the use of reinsurance or hedging, that returns on GAAP equity will be declining. It's something that we and our investor clients care about a lot.

MR. RIEGEL: In our discussions with companies, so far very few, if any, have run the results under C-3 Phase 2. They indicate that the final rules of the game have not been set. But we are anxious to get those results and incorporate them into our assessment of capital adequacy. We applaud the regulators. Although delayed in introducing it, it's a more accurate way of determining reserve and capital requirements. Right now most of the risk on the company's balance sheet is in those secondary guarantees. The stochastic modeling is much better than the current reserve regime for the secondary guarantees. It probably won't be until 2005 that we are able to fully incorporate it into our analysis.