



SOCIETY OF ACTUARIES

**SOA 2010 Annual Meeting & Exhibit  
Oct. 17-20, 2010**

**Session 112 PD, Rating Agency Perspective**

**Moderator:**

Basha H. Hoffman, FSA, MAAA

**Presenters:**

[Matthew Carroll](#)

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## SOA Annual Meeting: Rating Agency Perspective

Matt Carroll, CFA  
Director  
North American Life & Health Insurance Ratings

October 20, 2010

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### Agenda

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- **Corporate Default Rates & Credit Trends**
- **Current State of the Life Insurance Sector**
- **Sector Outlook Drivers**

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## Corporate Default Rates & Credit Trends

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### Key Takeaways

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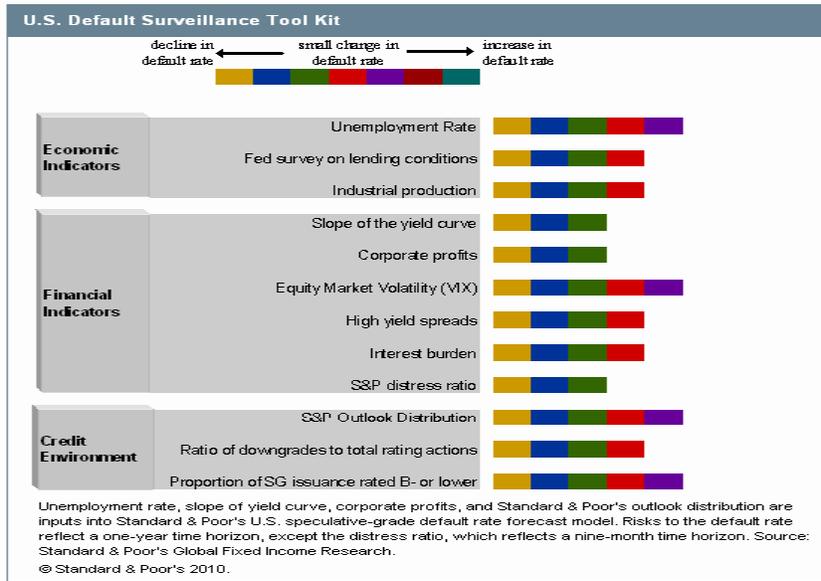
- **US speculative-grade corporate default rate declined to 4.5% from double-digit highs of 2009**
- **Baseline speculative-grade default forecast (60% probability) is 2.8% in next 12 months, ending in June 2011**
  - Pessimistic forecast is of 4.5%, which is the same as our long-term average (1981-2009)
- **After the one-year forecast, residual default risk could increase due to increasing debt maturities beyond the one-year horizon**
- **Although improved, in our view, generally weak economy has resulted in marked increase in risk pricing**
  - Spreads at spec-grade have widened 20%-24% in Q2 compared to Q1
- **Media and Entertainment sector remains the most vulnerable sector, given the high concentration of B- or lower credits**

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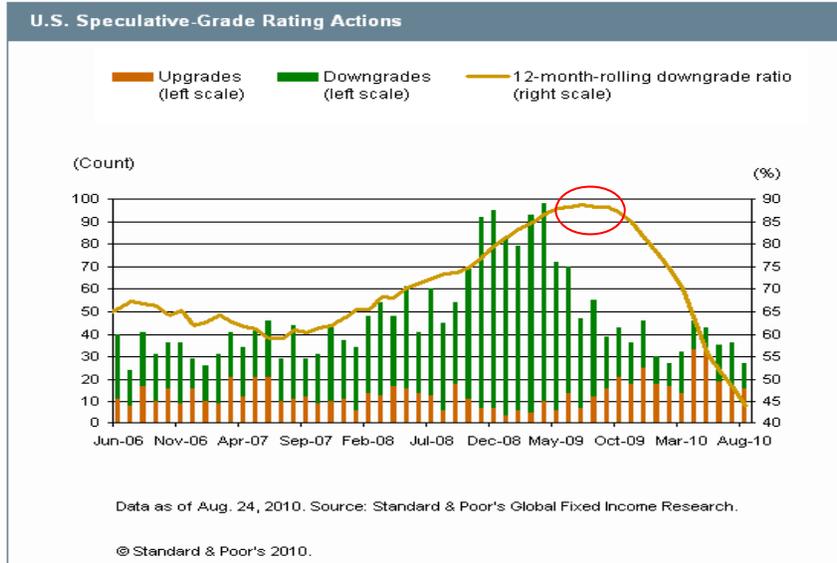
## U.S. Default Surveillance Toolkit



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## Improving Trends: Upgrades Exceed Downgrades



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## **Drivers For Near-Term Decline In Default Rates**

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- **Modest amount of maturing debt in the next four quarters**
- **Benign financing conditions in early months of 2010 enabled speculative-grade entities to tap market for financing**
  - Debt maturities were extended and financing costs lowered leading to lower default risks in the near-term
- **Credit quality appears to be stabilizing**
  - Deleveraging activity
  - Most new issuance related to refinancing instead of adding new debt

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## **Longer-Term View Remains Less Favorable**

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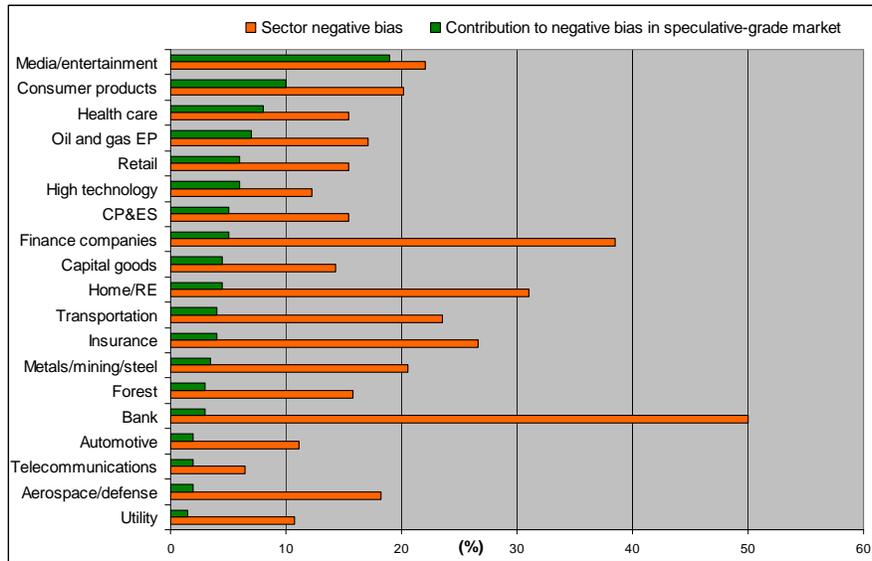
- **Economic growth will likely remain sluggish in 2011**
- **Significant overhang of leveraged corporate issuers and sizable debt**
  - \$120 billion of speculative-grade debt maturing in 2011; further \$198 billion maturing in 2012 followed by \$277 billion in 2013
- **Refunding needs will rise significantly; market may not have the appetite to absorb this**
  - Speculative grade spreads have increased in Q2 2010:
- **Absence of top-line growth and lower leverage means some of the speculative-grade companies could continue to suffer because of limited financial flexibility in the longer-term**

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## Decomposition Of Potential Downgrade Risk In Spec-Grade



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## Current State Of The Life Insurance Sector

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## Life Insurance Sector: The Past & The Future

- **2009 Recap:**

- Negatively impacted by capital erosion, reduced liquidity and financial flexibility, and weaker earnings
- Relatively modest impact on financial strength of life insurance sector
- Impact of recession was moderated by ERM developments
- Life Insurance sector remains a highly-rated sector

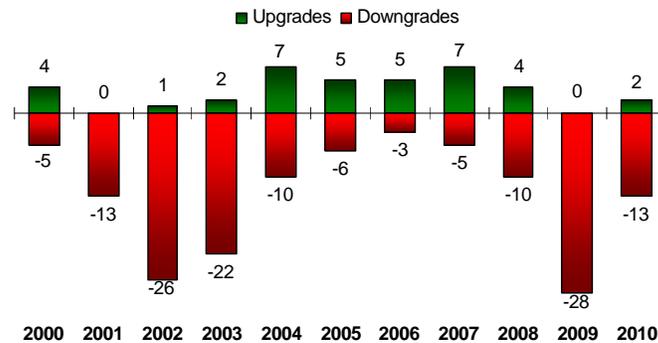
- **2010 Outlook:**

- Sector outlook remains negative
- Downgrades continue to overshadow upgrades
- Improving fundamentals, but expect lower run-rate level of earnings

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## Rating Trends: U.S. Life Insurance

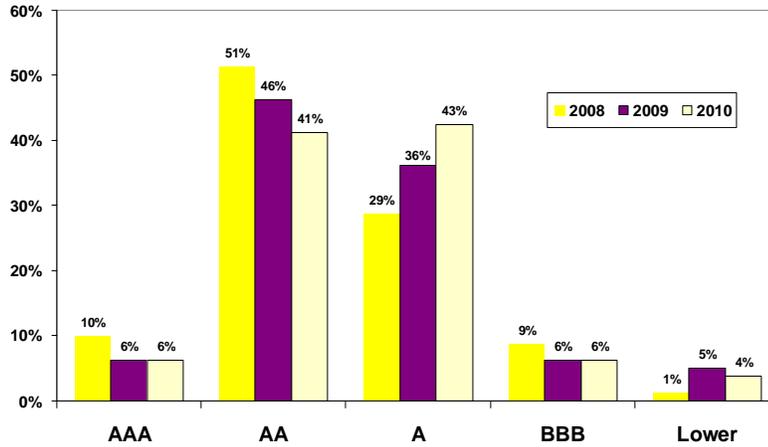


Multiple rating actions within a given year are included; 2010 Totals are through September 30

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## Rating Distribution: U.S. Life Insurance



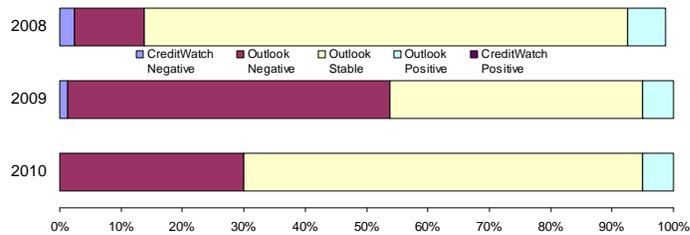
Ratings of 80 interactively-rated companies and groups as of September 30, 2010 looking backward to 2008 & 2009.

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## Rating Outlooks: U.S. Life Insurance



As of 9/30 of each year; 80 interactive ratings.

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## Sector Outlook Drivers

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## Outlook: Key Drivers

- **Operating Performance**
- **Capitalization**
- **Competitive Position**

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## Operating Performance: Stabilizing, But At A Lower Level

- **Continued drag on operating earnings**
  - GAAP operating earnings expected to modestly improve in 2010
  - Will remain lower than 2006-2007 highs
    - The asset portfolio and liabilities have created greater volatility on the income statement
    - Spread compression because of low yields and floored rates
    - Expense management can only go so far
- **GAAP fixed charge coverage levels will trend to lower levels**
  - Lower operating margins will keep pressure on coverage
  - Trending towards normalized ROE's of about 10%
- **Statutory operating earnings recovery remains critical to our view of stressed capital as per criteria \***

\* See Criteria Article: "Methodology For Incorporating Incremental Stress Factors Into The Capital Adequacy Analysis Of U.S. Insurers"

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## Capitalization: Downgrades Influenced By Capital Concerns

- **S&P introduced second phase of asset stress test in April 2010**
- **Individualized approach to real estate exposure in the industry**
  - CMBS and commercial whole loans – loan-level analysis
  - Real estate credit cycle generally lags the broader economy
  - Significant differentiation noted in discreet analysis
  - Expected losses vs. stressed losses
- **Companies continue to shore up capital base**
  - Delicate balancing act of maintaining operating company capital vs. holding company liquidity
  - Impact of slower business growth on statutory capital levels may bolster capital recovery
  - Macro-hedging is mitigating overall risks to capital
  - Deflation, persistent low interest rates, and the potential for a sudden spike in rates remain risks

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### **Capitalization/Financial Flexibility: Access To Markets A Mixed Bag**

- **Industry has shown the ability to access the traditional equity and debt markets**
- **Holding companies maintaining 12-18 months fixed charge coverage in response to credit crisis of 2007-2009**
- **Other funding needs are still getting lukewarm receptivity**
  - Low capacity for long-term letters of credit
  - XXX/AXXX (need for capital solutions may be addressed by creative product designs limiting need for access to capital markets)
- **Increased refinance concerns due to short duration funding**

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### **Competitive Position: Lower Demand / De-Risked Products**

- **De-risking impact on product attractiveness**
  - Funding of risk management costs is making products less competitive
- **Top-line continues to be pressured**
  - Lack of demand on protection products
  - Group sales affected by economic malaise
  - Recent LIMRA study shows that about 1/3 of US households don't own any life insurance – the lowest in over 50 years
- **Lower ratings may impact confidence-sensitive distributors and clients**
- **Employers continue to ratchet back benefits, placing greater onus on the individual to plan for retirement**
- **Sector remains well-positioned to capture the systemic need for protection, wealth accumulation and retirement income**

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## Emerging Issues

- **Financial Reform**

- International accounting convergence

- **Mergers & Acquisitions**

- Growth alone isn't the impetus for M&A
- Asset risks continue to hinder the completion of transactions
- Unique opportunities in marketplace due to financial stress
- Approaches that are effective: acquire to aspire and acquire to expire

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## Despite Concerns, Core Strengths Remain

***We Believe Strong Fundamentals Remain Intact, But  
Continued Market Pressures May Impact Ratings  
Downward***

- (-) Continued pressure on earnings
- (-) Capital constrained by additional investment losses
- (+/-) De-risking impact on returns and product attractiveness
- (+) Relatively stable insurance cash flows and strong liquidity from mortality and morbidity performance – long-dated liabilities
- (+) Well-positioned to capture opportunities in the retirement market
- (+) Systematic need for protection, wealth accumulation and retirement income

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# Life Insurance Industry Overview

Scott Robinson, Senior Vice President

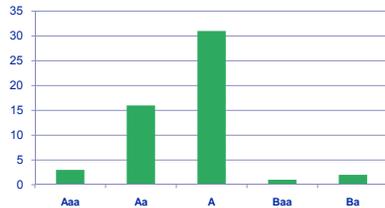
Society of Actuaries,  
October, 2010

## Agenda

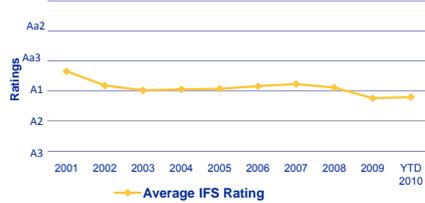
1. Rating Trends by Insurance Sector
2. Market Conditions for Insurers – What a Difference a Year Makes
3. Incorporating Base and Stress Scenarios into Ratings
4. Industry Outlook
5. Discussion of Selected Rating Factors
6. Other Issues Impacting U.S. Life Insurers
7. Conclusion
8. Appendix

## Ratings Trends in North American Life Insurance Sector

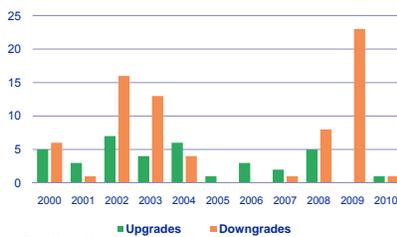
Rating Distribution (53 Groups)



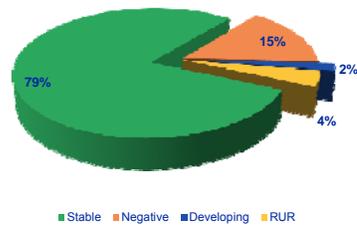
Insurance Financial Strength Rating



Upgrades and Downgrades



Outlook Distribution



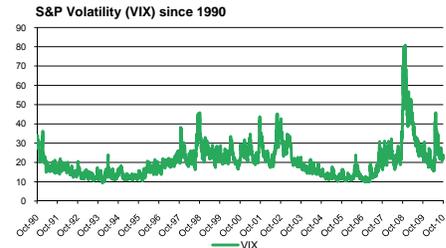
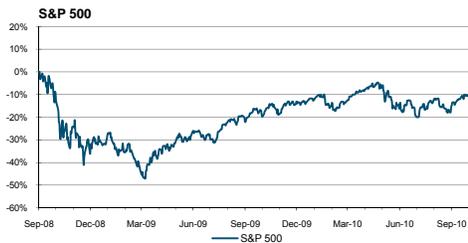
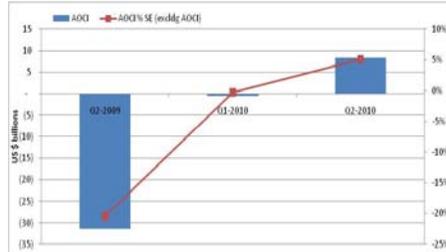
As of Sep 13, 2010

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## Market Conditions – What a Difference a Year Makes

- » Spread tightening across most asset classes
- » Reversed large unrealized losses in investments to small gains
- » Equity markets recovered with reduced volatility

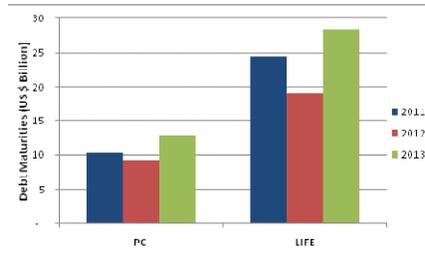
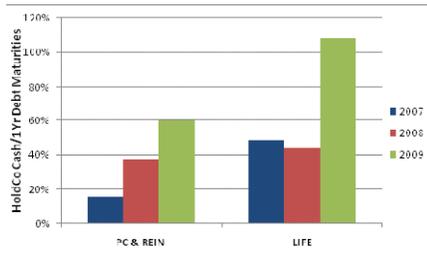


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## Market Conditions – What a Difference a Year Makes

- » Recession has ended and economy is slowly recovering
  - But recovery will be sluggish and constrained by high unemployment, modest growth, & budget deficits
  - GDP: 2.5%-3.5% growth in 2010-11
  - Unemployment: 9.5%-10.5% in 2010; 8%-9% in 2011
- » Improved access to capital markets for insurers
  - ~\$50 bil of capital raised in 2009-2010 (80% debt; 20% equity)
  - Refinance debt maturities, rebuild opco capitalization, strengthen holdco liquidity



## Insurers' Stock Prices and Valuations Rebounded Strongly, ...But Still Lagging 2006-2007 Levels



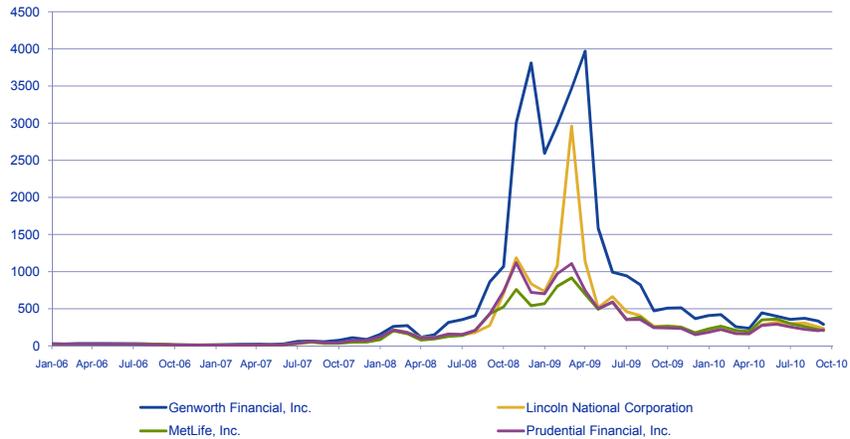
## Average Moody's Implied Rating vs Average CDS Implied Rating



## CDS Implied Rating - Life Insurance Companies



## CDS Spreads- Life Insurance Companies



## Incorporating Base and Stress into Scorecard (Life Insurers)

### Key Variables

Investment losses  
 Equity market decline impact on VA  
 Access to capital markets  
 Disruption of distribution  
 Operating income decline  
 Liquidity stress – opco  
 XXX / AXXX solutions



### Base and Stress Scorecards

Part 1 - Business Profile	Factor weight
Factor 1: Market Position and Brand	15
Factor 2: Distribution	10
Factor 3: Product Focus and Diversification	10
Part 2 - Financial Profile	Factor weight
Factor 1: Asset Quality	10
Factor 2: Capital Adequacy	15
Factor 3: Profitability	15
Factor 4: Liquidity and ALM	10
Factor 5: Financial Flexibility	15

## Incorporating Base and Stress into Scorecard

Financial Strength Rating Scorecard	Traditional Raw Score (1&5 yr metrics)	Last YE Raw Score (1 yr metric)	Current YE Base Case Raw Score (1 yr metric)	Stress Case Raw Score (1 yr metric)	Last published adjusted score	Base Case Adjusted Score	Stress Case Adjusted Score	Proposed Adjusted Score
<b>Business Profile</b>	Aa1	Aa1	Aa1	Aa2	Aa1	Aa1	A2	Aa2
Market Position and Brand (15%)	Aaa	Aaa	Aaa	Aa2	Aaa	Aaa	A1	Aa1
Relative Market Share Ratio	Aaa	Aaa	Aaa	Aa				
<b>Distribution (10%)</b>	Aa2	Aa2	A1	A1	Aa2	Aa2	Baa1	A1
Distribution Control	Aa	Aa	Aa	Aa				
Diversity of Distribution	Aa	Aa	Aa	A				
<b>Product Focus and Diversification (10%)</b>	Aa1	Aa1	Aa1	Aa2	Aa2	Aa2	A1	Aa2
Product Risk	Aa	Aa	Aa	Aa				
Life Insurance Product Diversification	Aaa	Aaa	Aaa	Aa				
<b>Financial Profile</b>	Baa1	Baa2	Baa2	Baa2	A2	A3	Ba1	Ba1
<b>Asset Quality (10%)</b>	Baa2	Baa2	Ba1	Ba2	Baa2	Baa1	Baa3	Baa1
High Risk Assets % Shareholders' Equity	118.4%/Baa	118.4%	133.3%	100.0%				
Goodwill & Intangible % Shareholders' Equity	72.0%/Ba	72.6%	112.2%	100.0%				
<b>Capital Adequacy (15%)</b>	Baa1	Baa1	Ba1	Ba2	Aa2	Baa1	Ba1	Baa1
Shareholders' Equity % Total Assets	5.5%/Baa	5.5%	5.4%	4.4%				
<b>Profitability (15%)</b>	Baa1	Baa1	Baa2	Ba2	A1	Baa2	Ba2	Baa2
Return on Capital (5 yr. avg)	7.1%/A	7.1%	4.0%	1.0%				
Sharpe Ratio of ROC (5 yr. avg)	93.6%/Ba	93.6%	96.0%	50.0%				
<b>Liquidity and Asset/Liability Management (10%)</b>	A2	A2	A3	A3	Aa2	A2	Baa1	A2
Liquid Assets % Liquid Liabilities	1.7x/A	1.7x	1.0x	1.0x				
<b>Financial Flexibility (15%)</b>	A3	Baa3	A3	Baa1	A2	A3	Ba1	Baa2
Adjusted Financial Leverage	28%/A	31.2%	29.0%	33.0%				
Total Leverage	51.5%/Ba	51.5%	52.1%	39.2%				
Earnings Coverage (5 yr. avg)	5.4x/A	-2.3x	3.6x	-1.5x				
Cashflow Coverage (5 yr. avg)	2.9x/Baa	3.3x	3.0x	1.0x				
<b>Operating Environment (5%)</b>	Aa	Aa	Aa	Aa	Aa	A1	Aa	Aa
Aggregate Profile	A2	A2	A2	A3	Aa1	A1	Baa2	A1

Greater than 3 notch differential between base and stress

## Industry Outlook – Positive Trends Drive Return to Stable

### Improvements:

- » Much improved financial flexibility
- » Equity-linked businesses recovering
- » Corporate credit losses subsiding
- » De-risking of products; more hedging
- » Economy slowly recovering

### Challenges:

- » AUM levels still depressed
- » CRE losses accelerating and RMBS losses continue
- » Investment income still down
- » Earnings/capital volatility from legacy VA
- » High unemployment/stagnant income → depressed sales
- » Risk of prolonged low interest rates
- » Impact of IOLI
- » Need for collateral to support XXX / AXXX

**Expectations of continued stabilization/improvement in the economy and capital markets support stable outlook**

## Business Profile – Good, but Legacy Issues Persist

- » Flight to quality
- » Continuing shift to guaranteed products carries risks
  - Mis-pricing of UL with secondary guarantees
  - Capacity/cost of XXX and AXXX reserve financing solutions
- » De-risking and repricing of products improves risk profile
  - VAs w/guarantees: But legacy VAs continue to be problematic and underpriced
  - Term insurance and UL: But IOLI/STOLI mis-pricing will be a drag on profits
- » Sales are recovering, but remain down

## Asset Quality – Good Overall, but CRE is Problematic

- » Asset classes of concern:
  - Commercial mortgage loans and CMBS (2006-2008 Aaa mez or lower; 2005 Aaa jr or lower)
  - Non-agency RMBS (pre-2005 vintage deterioration)
- » Elevated industry credit losses are moderating, but still high:
  - Bonds + preferred stocks: ~90 bp in '09 vs ~165 bp in '08
  - CML : ~70 bp in '09 vs ~20 bp in '08
  - expect lower 2010 losses overall, but still high relative to 25 bp normalized
- » Est. Moody's rated universe cumulative losses (pre-tax) for CML/CMBS for 2010+  
**Stress: ~\$45-50 bn ; Base: ~\$10 bn versus:**
  - Normalized statutory operating earnings ~ \$25-\$30 billion
  - Capital (TAC) ~ \$235 billion

## Capital Adequacy – Solid, but Management Behavior may Weaken it

### Positives:

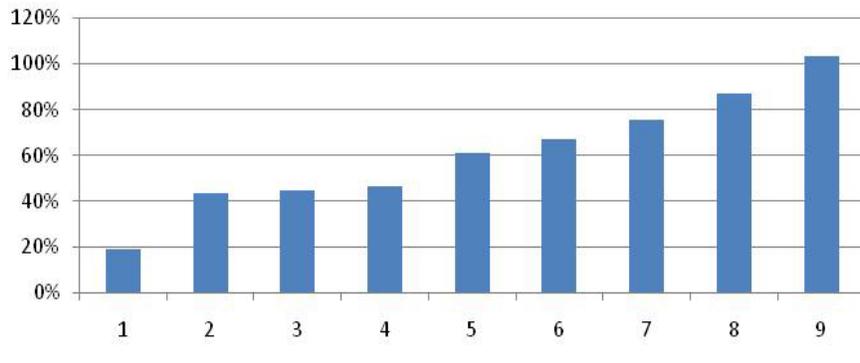
- » Absolute capital and RBC levels strengthened
- » Companies targeting higher levels of capital
- » Organic capital formation in 2010 to improve

### Negatives:

- » RBC ratio improvement was partly regulatory-driven
- » Volatility in capital for VA writers remains high; uncertainty regarding policyholder behavior
- » XXX/AXXX reserve financing still challenging
- » Management conservatism may be temporary
- » Financial Engineering drove some of the change (see following slide)

## No Doubt About it, VA Captives Undercapitalized

### Capitalization of Captives: Hard Capital to CTE 98



Source: Moody's Data

## Profitability – Took a Hit, Gradually Recovering

### Positives:

- » Investment income (excluding impact "I")
  - Investment losses are moderating
  - Reinvestment of cash in 2010
  - Alternative asset returns are improving
- » Equity market recovery reversed prior losses and is helping AUM levels recover

### Negatives:

- » Impact low "I" on investment income
- » CRE losses are accelerating
- » Still-depressed fee-based businesses
- » Lost earnings from Institutional Investment Product (IIP) runoff
- » Higher cost of expanded VA hedging programs
- » Continued volatility in earnings from investment losses and equity markets

## Financial Flexibility – Strong Recovery

### Positives:

- » Holding company liquidity much improved
  - Refinanced debt maturities in 2009-2011
  - More conservative holdco liquidity philosophy
- » Improvements in capital adequacy has relieved pressure on opco dividends
- » Earnings and cash coverage expected to gradually recover

### Negatives:

- » Earnings and cash coverage remain below historical norms
- » Management conservatism may be temporary

## Other Issues Impacting U.S. Life Insurers

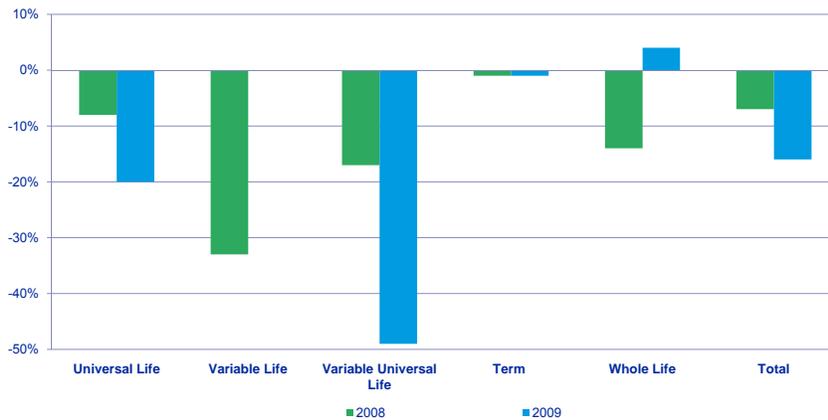
- » M&A activity expected to increase, but remain moderate near-term
  - Bid/Ask spread for businesses still wide
  - Cost of capital for potential buyers remains high
  - Management caution about preserving liquidity/capital
- Near-term, small-mid size acquisitions more likely
- Longer-term, expect more consolidation
  
- » Solvency II
  
- » Financial reform not expected to be a material factor
  - Derivatives
  - Office of National Insurance
  - Systemically important life insurers

## Conclusion

- » Industry has demonstrated its resilience under stress
- » Return to stable outlook reflects expectation of stabilization and improvements in economic and capital market conditions

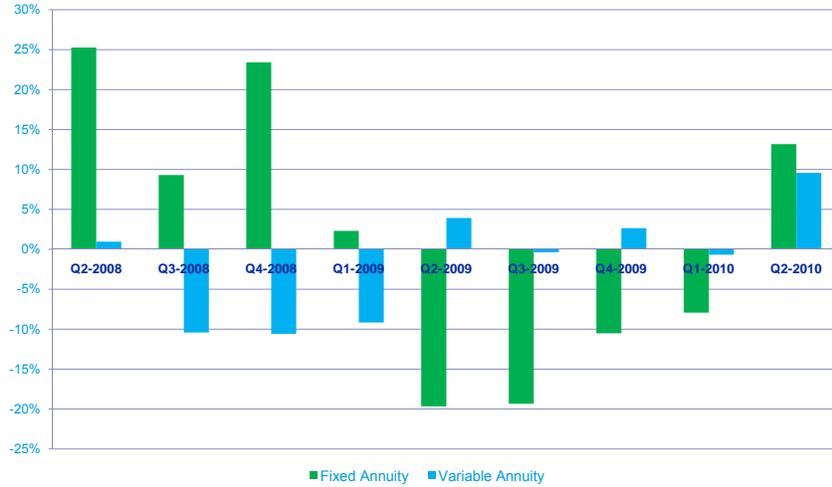
## Appendix

## Life Insurance Sales Growth by Premium (Yr over Yr % chg )



Source: LIMRA

## Individual Annuity Sales Growth (Qtr over Qtr % chg)

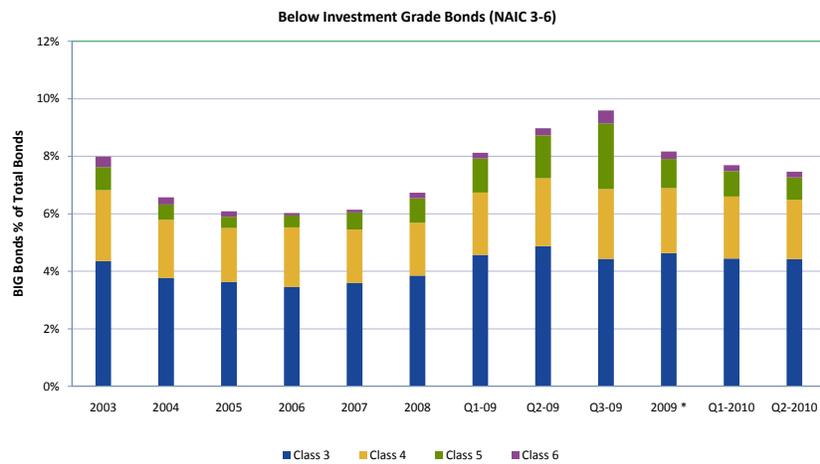


Source: LIMRA

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## Below Investment Grade Bonds % of Total Bonds

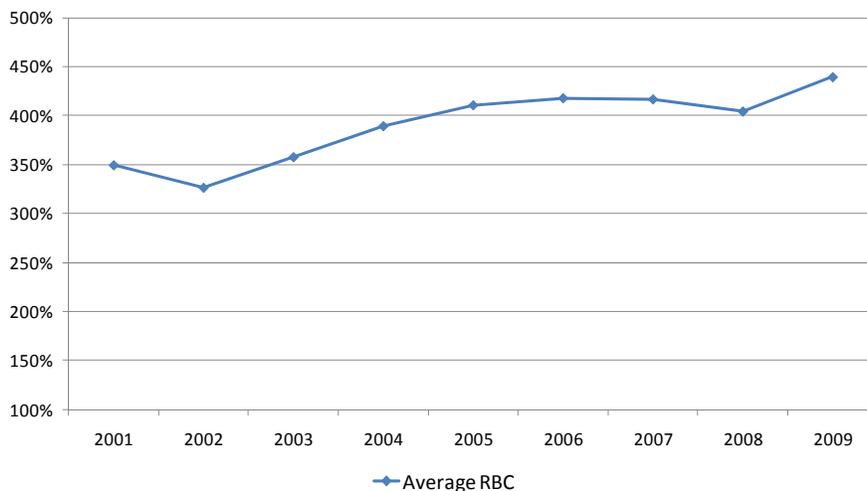


\*4Q09 rebound from RMBS re-rating

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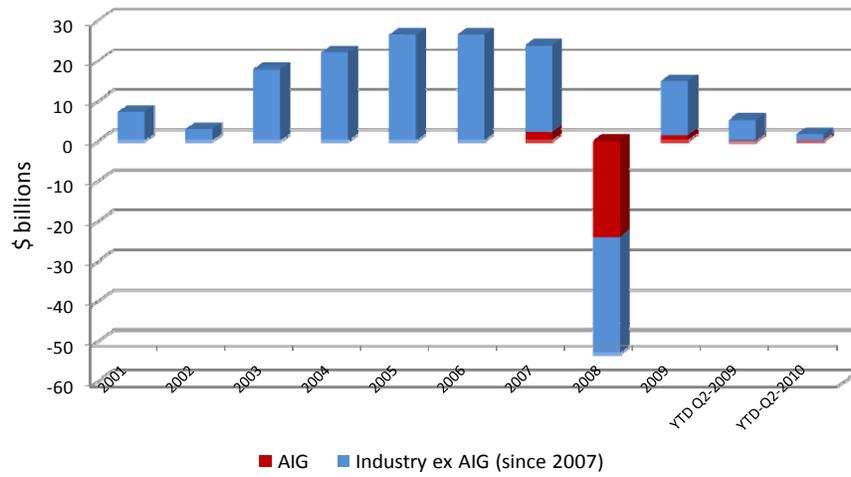
## NAIC RBC Ratio – Remains Solid but w/Regulatory Relief



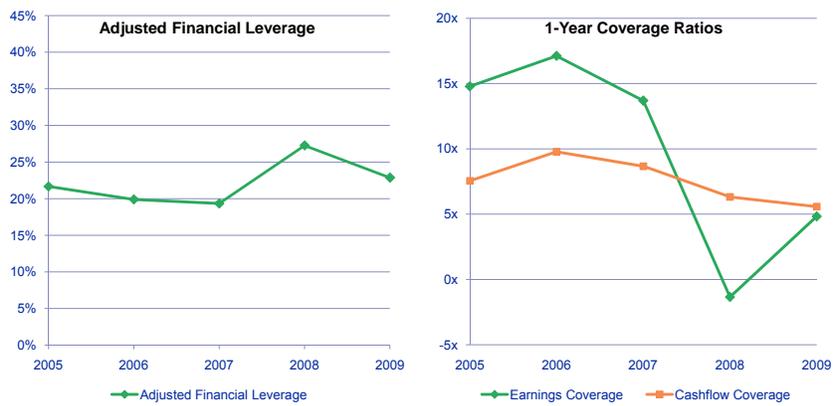
## Stat Capital and Surplus Improves 2% in YTD 2Q2010

(in US \$ millions)	2008	2009	YTD Q2-2009	YTD Q2-2010
<b>Capital and Surplus - BOY</b>	<b>208,018</b>	<b>195,258</b>	<b>195,767</b>	<b>224,756</b>
Net gain from operations	(7,982)	42,061	20,580	6,999
Net realized capital gains/(losses)	(45,172)	(26,624)	(15,215)	(5,538)
Net unrealized gains/(losses)	(15,307)	(9,029)	(11,072)	8,902
Non-admitted assets & related items	(32,868)	7,460	(3,566)	2,956
Net deferred income tax	32,906	(11,925)	(1,683)	1,221
Surplus notes	3,294	6,408	1,651	2,201
Asset valuation reserve	21,658	1,625	6,826	(6,281)
Dividends to stockholders	(14,640)	(4,286)	(2,646)	(4,903)
Paid in Capital	37,538	12,077	4,938	(273)
Write-ins	968	6,539	83	617
Other	6,270	4,312	59	(1,207)
<b>Capital and Surplus - EOY</b>	<b>194,683</b>	<b>223,876</b>	<b>195,724</b>	<b>229,449</b>
<b>\$ Change in Capital</b>	<b>(13,334)</b>	<b>28,617</b>	<b>(44)</b>	<b>4,693</b>
<b>% Change in Capital</b>	<b>-6.4%</b>	<b>14.7%</b>	<b>0.0%</b>	<b>2.1%</b>

## Stat Net Income - Strong Recovery, Boosted by Equity Market



## Financial Flexibility Metrics - Recovering, but Below Norms



Source: Moody's analysis of 45 insurance groups