

Financial Concepts, Inc. provides sophisticated insurance and wealth management services to families, business owners, corporate executives, professionals, and other successful high income and high net worth individuals. Our team of professionals utilizes a customized process of defining, understanding, researching, evaluating, and informing our clients of innovative and uniquely integrated solutions tailored to their diverse financial goals. Our desire is to help make the otherwise complex, more understandable as it applies to your unique situation.

Financial Strength of the Life/Annuity & Health Insurance Industry: Rating Agency Report Summary

In recent weeks, there have been a number of reports published by the major rating agencies highlighting the favorable financial trends for the life/annuity & health insurance industry. A synopsis of these reports, as listed below, is provided in this Special M Due Care Update.

- **A.M. Best Special Report:** Gradual Improvements Have Life/Annuity Rating Trends Leaning Toward Equilibrium (March 7, 2011)
- **A.M. Best Special Report:** U.S. Life/Health Industry Recovers Lost Ground as Key Economic Indicators Improve (February 21, 2011)
- **Standard & Poor's Report:** Stronger Credit Quality is Helping U.S. Life Insurers to Withstand Commercial Real Estate Losses (March 30, 2011)
- **Fitch Report:** Outlook for U.S. Life Insurance Industry Stable as Credit Fundamentals Improve (January 11, 2011)
- **Moody's Report:** Solid Capital Levels for U.S. Life Insurers at YE 2010; Pressure to Redeploy "Excess" Capital (March 25, 2011)

Copies of these reports are available from the M Product Management team.

A.M. Best Special Report: Gradual Improvements Have Life/Annuity Rating Trends Leaning Toward Equilibrium

A.M. Best sees life/annuity companies emerging from the lows seen during the financial crisis and continuing to strengthen their balance sheets and liquidity profiles. As a result, given the industry's overall improvement in its financial condition, the life/annuity segment's rating outlook was revised to stable in July 2010.

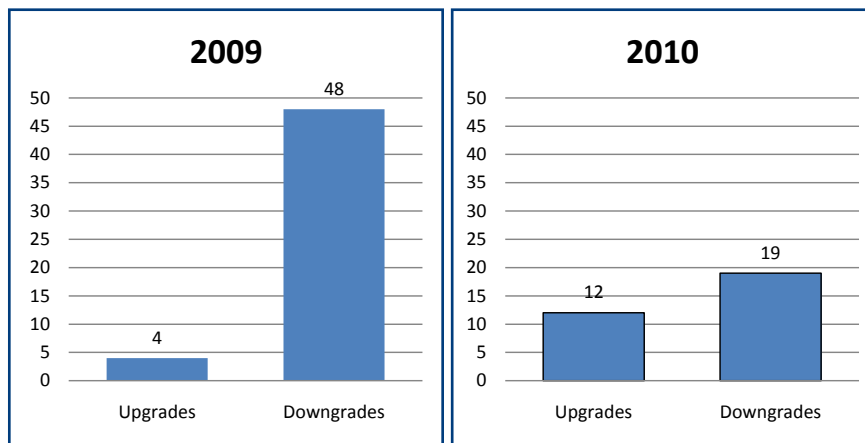
- A.M. Best observed several significant trends in 2010: a slow but steady improvement in overall economic conditions; enhanced capital positions at operating and holding companies; lower unrealized and realized investment losses; and refined risk management practices.
- Notably, industry players were: focusing more on liquidity; increasing scenario/stress testing; performing product segment and corporate structure reviews; redefining risk appetites; and emphasizing statutory capital levels.
- The financial crisis and associated deterioration in economic fundamentals were the primary factors leading to the continued negative rating actions taken in the life/annuity segment in 2009. Negative rating actions subsided as conditions improved, investment portfolios stabilized, and equity markets hit "post-crisis" highs.



Financial Strength of the Life/Annuity & Health Insurance Industry: Rating Agency Report Summary (continued)

Although negative rating actions outnumbered positive ones during 2010 (see charts below), A.M. Best believes life/annuity ratings have stabilized for the near-to-medium term and 2011 rating changes are likely to resemble the trends of the mid-2000s. In the three-year period of 2004 through 2006, the ratio of rating unit upgrades to downgrades hovered in the 65–88% range.

Exhibit: U.S. Life/Annuity Rating Changes*



* Source: A.M. Best Co.

That said, A.M. Best believes that challenges remain from a regulatory, economic, revenue and earnings growth, and competitive standpoint.

A.M. Best Special Report: U.S. Life/Health Industry Recovers Lost Ground as Key Economic Indicators Improve

During 2010, the total U.S. life/health industry rebounded and recovered lost ground attributed to the “Great Recession.” Financial results in 2010 demonstrated an increase in admitted assets, continued favorable trends in absolute and risk-adjusted capital levels, organic earnings growth, and significantly diminished levels of credit impairments. As a result, fundamentals for the vast majority of life/health companies have improved, despite a challenging macroeconomic landscape.

Credit spreads have largely normalized for most asset classes, the pace of credit impairments has slowed, access to capital markets remain fluid, and the industry’s balance sheet has been bolstered by the decline in credit spreads and sizeable capital raises completed during 2010. These trends should continue to offset potential earnings volatility should the equity markets reverse course. Additionally, A.M. Best believes the capital positions of highly rated companies will be able to withstand future impairments within residential and commercial real estate.

However, low interest rates continue to be a major issue facing life insurers as they struggle with ongoing spread compression and limited high-yield investment options.

Standard & Poor’s Report: Stronger Credit Quality is Helping U.S. Life Insurers to Withstand Commercial Real Estate Losses

As the pressure on commercial real estate (CRE) began to mount in 2008, U.S. life insurers increased their focus on their CRE portfolios. The industry’s exposure to CRE—which includes CMBS and commercial mortgage loans (CML)—is significant, accounting for about 18 percent of total invested assets.

Life insurers have withstood the downturn in CRE by maintaining adequate capitalization levels as they purchased generally higher-quality CMBS; also, their CML investments performed relatively well. Many insurers also have limited any significant new investments in CRE over the past few years.

In addition, life insurance companies have been strengthening their balance sheets and maintaining somewhat more conservative liability profiles as the financial markets recover. This contributed to Standard & Poor’s (S&P) decision

to revise its outlook on the U.S. life insurance sector to stable from negative in December 2010. S&P has seen many companies take meaningful steps to rebuild capital and liquidity and believes that improving credit quality—particularly stronger capitalization levels—will enable life insurers to withstand any further CRE-related losses.

Life Insurers' CMLs Perform Better Than Their CMBS Investments

U.S. life insurers' CML investments have generally performed better than CMBS, largely because of conservative lending practices and underwriting standards. Conservation is a hallmark of insurance real estate lending and has helped to keep delinquency rates on CMLs relatively low. As of December 31, 2010, the delinquency rate of the CMLs in rated life insurers' portfolios was 0.2 percent, versus a delinquency rate of approximately 9 percent for the entire CMBS sector.

Fitch Report: Outlook for U.S. Life Insurance Industry Stable as Credit Fundamentals Improve

Fitch Ratings' (Fitch) outlook for the U.S. life insurance industry in 2011 is stable as material improvement in the industry's balance sheet and operating fundamentals will be sustained over the coming year.

Industry capitalization and liquidity have strengthened significantly over the past year, driven by improved investment valuations and financial market liquidity. This has resulted in a significant reduction in gross unrealized losses and realized investment losses in 2010, and has allowed the industry to raise new capital and fund near-term maturities. Fitch expects favorable trends in industry earnings performance and investment results reported in 2010 will continue over the near term. Earnings will, however, continue to lag pre-crisis results due to the lower interest rate environment and increased hedging costs, as well as steps taken by the industry to exit non-core businesses, redesign products, and reduce risk in the investment portfolio.

Over the next 12–18 months, Fitch's primary rating concerns for the U.S. life insurance sector include:

- Uncertainty over the economic outlook and the potential for a double dip recession.
- Higher than expected losses on CRE-related assets.
- Emerging interest rate risk due to historically low interest rates, which are affecting industry investment yields and profitability, and uncertainty regarding the future direction of interest rates.

Fitch's outlook assumes a continued, albeit weak, economic recovery with modest GDP growth and a continued high unemployment level.

On the regulatory front, Fitch believes that the passage of the Dodd-Frank bill in 2010 is a credit-neutral event for the U.S. life insurance industry, although there remains much uncertainty over the interpretation of several aspects of the bill.

Fitch revised its outlook on the U.S. life sector to stable from negative in September 2010.

Moody's Report: Solid Capital Levels for U.S. Life Insurers at YE 2010; Pressure to Redeploy "Excess" Capital

Upon review of 2010 year-end statutory statements filed by Moody's universe of rated U.S. life insurance companies, Moody's concludes that the industry continues to remain well capitalized, with improvement in terms of both absolute amount of capital and risk-based capitalization.

Looking through 2011, Moody's expects that publicly-traded companies will continue to be under pressure from shareholders to rationalize their historically high capital levels in order to improve ROEs. After two years of taking a conservative financial posture, many companies are starting to cautiously re-leverage and re-risk their balance sheets.

Financial Strength of the Life/Annuity & Health Insurance Industry: Rating Agency Report Summary (continued)

The key takeaways of Moody's industry analysis of capital levels are:

- Overall, the median National Association of Insurance Commissioners (NAIC) Risk-Based Capital (RBC) ratio for Moody's universe of rated lead statutory companies improved to 454 percent as of YE 2010 (from 425 percent at YE 2009).
- The absolute level of consolidated statutory capital and surplus increased by 9 percent to \$255 billion.
- Dividends up-streamed from operating companies in 2010 increased to \$12 billion from \$4 billion, and companies have restarted share repurchase programs.
- All else equal, those companies that are more vulnerable to downside scenarios, potentially because of significant exposure to legacy blocks of variable annuities with guarantees and/or real-estate related assets, will have a greater need for maintaining a "capital cushion."

M Financial will continue to monitor developments and publish related communications as warranted.

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