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DUE CARE BULLETIN

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Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.

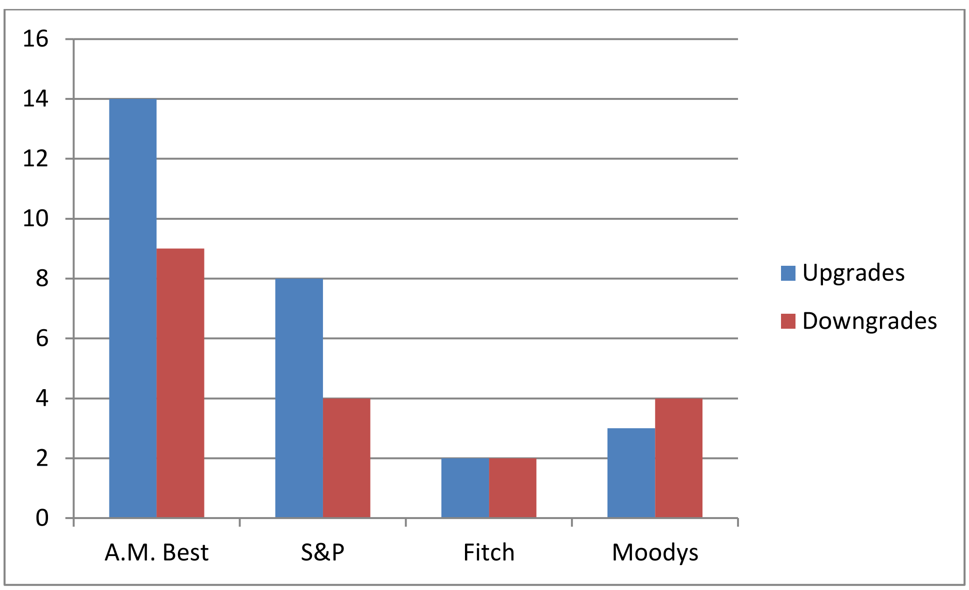
M Financial Group continues to lead the industry in life insurance due care and client advocacy, providing valuable insight and analysis that delivers significant value to clients.

Update on U.S. Life Insurance Financial Strength Rating Changes in 2013

The U.S. life insurance industry ended 2013 on an upward trajectory with regard to financial strength metrics and ratings. Relative to 2012, all four major rating agencies reported improvement in various aspects of their financial strength ratings. This could be seen in higher aggregate ratings and a higher number of upgrades than downgrades during 2013. In addition, according to A.M. Best, no U.S. life and health insurance companies were impaired[1] in 2013. Since A.M. Best started tracking life insurer impairments, this is the first year no companies required regulatory intervention.

During 2013, financial strength rating upgrades by the four major rating agencies outnumbered downgrades by a margin of 27 to 19. See Figure 1.

Figure 1. Summary of 2013 Financial Strength Rating Upgrades and Downgrades[2]



1 A.M. Best designates an insurer as a financially impaired company as of the first official regulatory action taken by a state insurance department. State actions include supervision, rehabilitation, liquidation, receivership, conservatorship, cease-and-desist orders, suspension, license revocation, and certain administrative orders.

2 Data for A.M. Best as of October 22, 2013. Data for S&P as of November 30, 2013. Data for Moody's as of December 4, 2013. Data for Fitch as of December 18, 2013.

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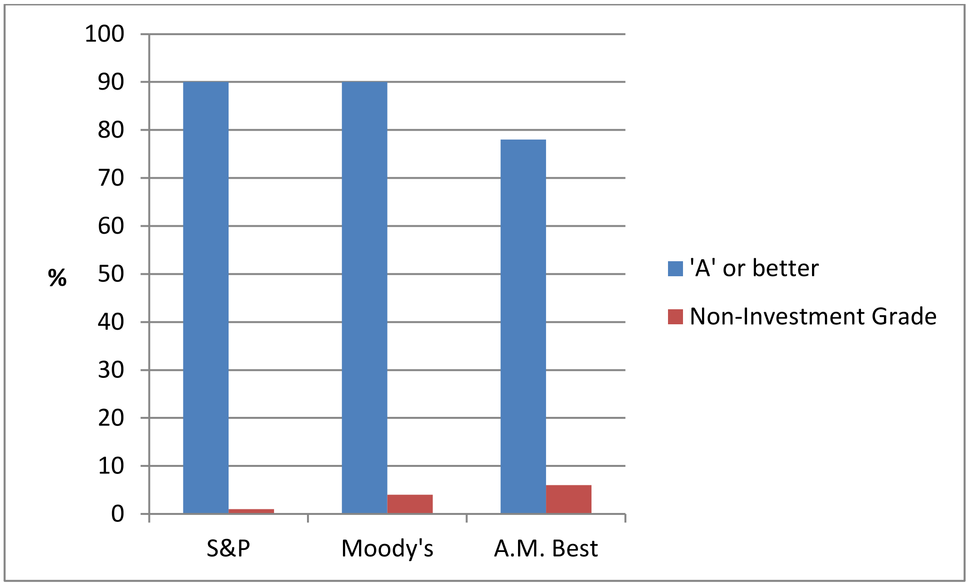
At the end of 2013, of all rated U.S. life insurers, 90% (S&P and Moody's) and 78% (A.M. Best) had investment grade (i.e., 'A' or better) financial strength ratings. See Figure 2.

Figure 2. 2013 Financial Strength Ratings Distribution[3]

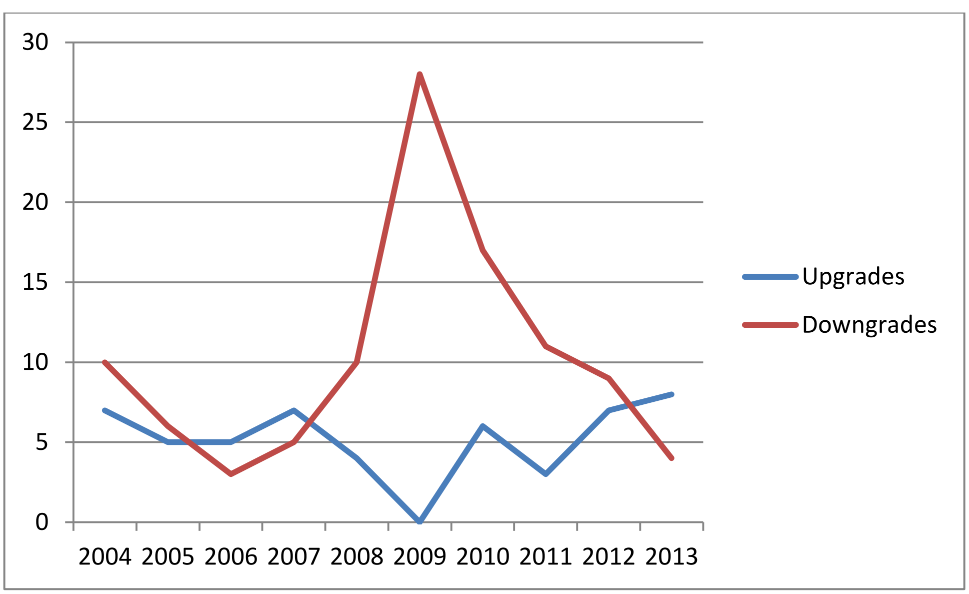


Below is a summary of recent commentary issued by each rating agency with respect to industry financial strength.

Standard & Poor's

S&P said in its most recent U.S. life insurance industry outlook that the credit quality of the industry remains stable, with headwinds subsiding and the economy continually improving. Companies with investment grade insurer financial strength ratings exhibit strong capital and liquidity, and stable investment portfolios. For the first time since 2007, S&P issued more upgrades (eight) on life insurers than downgrades (four). See Figure 3.

Figure 3. S&P U.S. Life Insurance Upgrades and Downgrades



3 Data for A.M. Best as of October 22, 2013. Data for S&P as of November 30, 2013. Data for Moody's as of December 4, 2013. Data for Fitch as of December 18, 2013.

As of November 30, 2013, S&P had an 'A3' (Strong) rating or better on 90% of their 82 rated life insurance groups and more than 91% had a stable or positive outlook.

Moody's

Moody's recently upgraded its outlook for the U.S. life insurance industry to stable from negative, which was the outlook since September 2012. Moody's stated its view that the downside risks to the industry have diminished and should allow revenues and earnings to stabilize over the next 12-18 months.

Moody's provides financial strength ratings for 52 U.S. life insurance groups. As of December 4, 2013, Moody's rated 90% of these groups at 'A3' (Good) or better; 88% of ratings had a stable or positive outlook.

A.M. Best

A.M. Best said the U.S. life and annuity sector has maintained strong risk-adjusted capital, steady operating earnings, and improved balance sheet fundamentals and continues to have a stable rating outlook for the industry.

At the end of 2013, A.M. Best had an 'A-' issuer credit rating (Excellent) or better on more than 78% of its rated companies. Ninety percent of the ratings have a stable outlook; the remaining 10% is split evenly between positive and negative outlook. A.M. Best also issued more rating upgrades (14) than downgrades (nine) during the year, which continued a trend observed over the past three years.

Fitch Ratings

Fitch continues to maintain a stable outlook for the U.S. life insurance industry, which it says reflects the industry's very strong balance sheet fundamentals, solid liquidity profile, and improved operating performance. Fitch also said it believes the industry is well positioned to withstand macroeconomic challenges over the coming year.

Nearly all of Fitch's 2013 rating actions through the third quarter were affirmations, with just two upgrades and two downgrades. As of December 18, 2013, 83% of their ratings had a stable or positive outlook.

Looking ahead to the remainder of 2014 and beyond, there are several areas of focus for rating agencies.

Interest Rates

The risk posed by low interest rates is declining as conditions improve and rates are expected to continue to rise gradually. A gradual increase in interest rates will relieve pressure on life insurers' profits. However, rates remain very low from a historical perspective and continue to put downward pressure on spreads and operating fundamentals. While the risk is viewed as manageable, concern remains about strategies some life insurers may use to generate incremental yield.

Macroeconomic Stability and Improvement

The economy has showed signs of improvement, albeit slow by historical standards. The economy is still viewed as being in a recovery mode, but economists see that recovery as vulnerable to a number of risks, including, but not limited to, disruption caused by the end of monetary stimulus (i.e., quantitative easing); legislative gridlock related to budget battles in the U.S. Congress; and a flare-up of the euro region debt crisis.

Update on U.S. Life Insurance Financial Strength Rating Changes in 2013 (continued)

Equity Markets

Rising equity markets will continue to improve the performance of variable annuity portfolios and other assets under management-fee driven businesses. While equity market performance has been very good overall since 2009, rating agencies remain concerned about potential volatility in equity prices and the resulting impact on insurers' financial performance.

U.S. Life Insurance Industry Asset Portfolio Credit Quality

The concerns about the previous three items weigh heavily on the industry's asset portfolio credit quality. Credit-related impairments since the financial crisis have continually been below expectations and historical averages. Rating agencies expect credit-related investment losses to remain below pricing assumptions and historical averages even if the economic recovery stalls. But they will be watchful to see if insurers increase the risk profile in their investment portfolios should interest rates remain near historical lows.

Summary

Since the financial crisis of 2008-2009, investors and policyholders have experienced a heightened sense of anxiety about the financial strength of life insurance companies. However, the failure rate of life insurance companies remains low in the wake of the financial crisis, with no impairments occurring in 2013. While financial strength ratings for life insurers understandably were lowered during the financial crisis, the industry generally remained resilient and has emerged with ratings that are on par with levels seen pre-financial crisis. While risks remain, life insurers are successfully managing their assets and liabilities to address these risks as exhibited by the current stable outlook provided by the rating agencies.

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