ATLAS
ADVISORY GROUP, LLC
Grow Protect Preserve

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.

Assessing the Impact of the Decline in the Commercial Real Estate Market

Introduction: Concerns about the stability of life insurers and other financial service companies are growing as economists predict that the commercial real estate and mortgage market will be the next domino to fall in the current recession. Life insurers allocate approximately 15% of their assets to commercial mortgage-related investments. Real estate values have fallen dramatically over the past two years and in light of tighter credit markets, forecasters predict a dire scenario for commercial mortgages. Default levels on commercial mortgages have risen to their highest levels in more than 15 years and are expected to continue to rise through 2010.

Commercial Mortgage Outlook: Life insurers issue about 10% of the commercial mortgages in the U.S. In addition, they invest in commercial mortgage-backed securities (CMBS), which comprise between 25% and 35% of the market. The bulk of the remaining market, approximately 50%, is issued by banks. These assets—bank-issued commercial mortgages, CMBS, and life insurer-issued commercial mortgages—each have different characteristics; therefore default rates will vary for each group, according to financial analysts.

Banks tend to issue commercial mortgages with shorter durations, usually less than five years, which match their short-term liability structure. They also have a higher concentration of construction loans and loans that do not generate cash flow. Since most of these loans would have originated between 2005 and 2009, a period of time when underwriting standards had deteriorated and become much more aggressive, expected losses on these loans are quite high.

In contrast, life insurers tend to prefer to issue loans with terms of ten years or more, matching the long-term nature of their liabilities. These loans tend to generate predictable cash flows, are less likely to be in need of refinancing, and have moderate loan-to-value ratios. Most of the commercial loans held by insurance companies were issued prior to 2006 when underwriting standards were more stringent. Not surprisingly, expected losses for this class of commercial mortgages are much lower than those held by banks.

CMBS occupy a middle ground between bank-issued and life insurer-issued commercial mortgages. CMBS tend to be comprised of loans with terms of between five and ten years. The general consensus is that loans backing CMBS are somewhat less risky than those held by banks and somewhat more risky than those held by insurance companies. Recent delinquency rates support this perspective. As of the end of 2008, the delinquency rate was 5.36% for banks, 0.95% for CMBS, and 0.07% for insurance companies.

According to industry analysts, it is unlikely the stress from defaults and foreclosures on commercial mortgages will severely impair the financial strength of life insurers, despite projections that losses will accelerate through 2011, and possibly beyond. While the extent of the downturn in the commercial mortgage market is uncertain, Moody's uses a cumulative ten-year expected loss projection of between 3% and 4% for losses on CMBS , and between 7% and 9% in an adverse scenario, in rating CMBS. For commercial mortgages issued by life insurers, Moody's predicts that loss rates could triple from their historical rate of 0.8%.

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Fitch Ratings stated their opinion that although increased losses are expected on commercial real estate-related assets, the loss exposure for U.S. life insurers will be "mitigated relative to other market participants due to their investment in higher credit quality assets and relative conservative underwriting." Fitch's projection for potential losses for the industry under stress scenario testing ranged from 8% to 10% of industry capital.

According to Standard & Poor's, life insurers generally invest in the "most senior and highest quality" tranches of CMBS and 95% of the industry's holdings are rated A or better. In addition, S&P says stress testing of insurer portfolios indicates that foreclosures would have to exceed 5% before any impact on ratings is seen, although companies with higher allocations to commercial mortgages would be more vulnerable.

Conclusion and M Partner Carrier Exposure: It is expected that delinquencies, foreclosures, and restructurings will rise in 2010 on commercial real-estate related assets. The impact on life insurers will be increased investment losses (realized and unrealized) on these assets. However, it is not expected that these losses will severely weaken the financial strength of U.S. life insurers or cause significant rating downgrades since current financial strength ratings already take these factors into account. Exceptions would be insurers with large exposures to CMBS issued between 2006 and 2008 or insurers with above average investments in direct commercial mortgages that have above average delinquency/foreclosure rates.

No M Partner Carrier has allocations to CMBS in excess of 5% of total invested assets. Prudential has the highest allocation at 4.5%. The percentage of CMBS rated AAA ranges from a low of 71% (Nationwide) to a high of 95% (Prudential).

The average investment allocation in commercial mortgages by M Partner Carriers is 11%, with Unum at the low end (3.2%) and Nationwide at the high end (18.4%). The percentage of impaired or delinquent commercial mortgages is below 2% for all of the companies.

Below is a detailed description of the commercial mortgage exposure for M Partner Carriers as of September 30, 2009.

	% of Invested Assets, Commercial Mortgages	% of Invested Assets, CMBS	Total	% of CMBS rated AAA	% of CMBS issued <2006
Lincoln	9.6%	3.0%	**12.6%**	73.6%	86.3%
Manulife	11.2%	2.8%	**14.0%**	90.0%	90.0%
Nationwide	18.4%	3.0%	**21.4%**	71.1%	**
Pacific Life*	13.6%	2.4%	**16.0%**	88.0%	81.0%
Prudential	10.9%	4.5%	**15.4%**	95.0%	44.5%
Sun Life	13.0%	1.7%	**14.7%**	72.7%	80.5%
Unum	3.2%	0.0%	**3.2%**	**	**

* Pacific Life data as of June 30, 2009
** Data not available

For More Information

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Appendix – Detailed Commercial Mortgage/CMBS Exposure By Carrier

Lincoln

Owns \$7.277 billion in commercial mortgages (9.6% of invested assets). A total of 0.62% of commercial mortgage holdings are delinquent by two or more payments. The largest concentrations of holdings by state are in California (21%), Texas (9%), Maryland (6%), and Florida (5%).

Has \$2.291 billion in CMBS and commercial real estate collateralized debt obligations (CRE CDO), which equals 3% of their invested assets. The vintages of CMBS and CRE CDO holdings are as follows:

64.1% issued in 2004 and prior

22.2% issued in 2005

6.5% issued in 2006

7.2% issued in 2007

The ratings breakdown for Lincoln's CMBS and CRE CDO holdings are as follows:

73.6% rated AAA

13.2% rated AA

6.4% rated A

4.0% rated BBB

2.8% rated BB and below

Manulife

Has a combined total of \$21.17 billion (11.2% of invested assets) in commercial mortgages. The average loan-to-value ratio (LTV) is 63% in the U.S. and 64% in Canada. A total of 0.31% of U.S. assets and 0.16% of Canadian assets are in arrears.

Owns \$5.285 billion in CMBS (2.8% of invested assets). Ninety percent are rated AAA and approximately 90% were originated in 2005 or earlier.

Nationwide (data for Nationwide Financial Services)

Commercial mortgage holdings total \$7.047 billion (18.4% of invested assets). A total of 0.04% of commercial mortgages are considered delinquent.

Owns \$1.156 billion in CMBS (3.0% of invested assets). Of these investments, 71.1% are rated AAA, 10.1% are rated AA, and 18.9% are rated A or below.

Pacific Life (information as of June 30, 2009)

Holds \$6.053 billion in commercial mortgages (13.6% of invested assets). The portfolio has no delinquent loans.

Has \$1.076 billion in CMBS (2.4% of invested assets). Of these investments, 88% are rated AAA and less than 1% are considered below investment grade; 81% were issued in 2005 or earlier.

Appendix – Detailed Commercial Mortgage/CMBS Exposure By Carrier (cont.)

Prudential

Owns $28.2 billion in commercial mortgages (10.9% of invested assets). The average LTV is 65% for assets held in the Financial Services Business and 58% for assets held in the closed block. Less than 0.5% of loans are delinquent, restructured, or in foreclosure.

Owns $11.6 billion in CMBS (4.5% of invested assets). Of these investments, 95% are rated AAA.

19.1% issued in 2004 and prior

25.4% issued in 2005

34.5% issued in 2006

18.5% issued in 2007

2.6% issued in 2008

Sun Life

Holds $13.9 billion of commercial mortgages (13% of invested assets). Of these, 32% have a LTV of 55% or lower and 36% have a LTV of between 55% and 75%. A total of 12% are government insured.

Holds $1.869 billion of CMBS (1.7% of invested assets), 73% of which are rated AAA. The vintages of CMBS holdings are as follows:

58.8% issued between 1997-2004

21.7% issued in 2005

13.8% issued in 2006

4.2% issued in 2007

0.2% issued in 2008 or later

The ratings breakdown for Sun Life's CMBS holdings is as follows:

72.7% rated AAA

7.3% rated AA

7.8% rated A

7.7% rated BBB

4.5% rated BB and below

Unum

Holds $1.375 billion in commercial mortgages (3.2% of invested assets). Impaired loans are 0.8% of the total portfolio.

Has $4.2 million in CMBS, less than 0.01% of invested assets.