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Annuity Math Anxiety

Consumers wonder if they are exposed to more risk as some insurers get regulatory relief in calculating their reserves

By **LESLIE SCISM**

While the biggest financial headlines over the past few months have focused on bailing out banks and other businesses with taxpayer money, many owners of annuities and life insurance are following another rescue attempt, with some bewilderment: efforts by insurers to get tens of billions of dollars in relief from state insurance regulators.

The insurers are asking states not for cash, but rather for rule changes that could spare them from having to set aside billions of additional dollars to show they can make good on their obligations to consumers. Some measures would reduce the reserves that insurers are required to hold against expected future expenses, and others would expand what they can count as capital.

What many consumers are wondering is this: Would the changes come at their expense? Annuities and insurance policies represent a substantial part of many families' financial security, and customers are concerned about any maneuver that puts those policies at risk, even if only slightly.

And consumers have another question, too: Do the insurers actually need the relief?

Here's a summary of events: Last November, as the stock market was headed toward a low point of the year and debt markets were virtually frozen, the American Council of Life Insurers, or ACLI, a trade group, asked an organization of state regulators, the National Association of Insurance Commissioners, or NAIC, to ease nine particular rules, all in place to protect policyholders. The ACLI maintained that the industry needed an easing in time for insurers' annual financial filings for calendar year 2008 because, with markets in turmoil, raising new capital might not be possible at a reasonable cost.

Though insurers are regulated by states, the NAIC sets financial standards that states generally follow. The NAIC assigned a team of technical experts to review the proposals, and by January the team had cleared six of them, with some modifications.

Then, amid mounting opposition from consumer groups and independent watchdogs, the NAIC's executive committee on Jan. 29 nixed the package, saying the ACLI hadn't made its case for rushed action. The vote coincided with an upturn in both stock and bond markets.

Over the past month, as the stock market resumed sliding, some of the nation's biggest insurers -- including [Allstate Corp.](#), [Hartford Financial Services Group Inc.](#) and [Lincoln National Corp.](#) -- won permission from their state regulators for some of the easing that the NAIC rejected. Under state-based regulation, states have the ability to grant exceptions to the rules, and have done so occasionally over the years. Insurers' filings for 2008 are due today in most states, and dozens of additional exceptions are expected to surface.

Here's what you need to know as events continue to unfold:

Let's start with the bottom line: Is this aid going to hurt consumers?

First, some terminology. Insurers set up reserves to back their obligations, and they keep ample additional sums of money on hand in case reserves fall short. This additional money is their capital, or net worth. Insurers hold the bulk of their reserves and capital in investment-grade corporate bonds and mortgage-backed securities.

"The proposals will lower the level of reserves and other dollars that today protect America's consumers," the Consumer Federation of America and the Center for Economic Justice wrote in comments filed with the NAIC on Jan. 27. "This approach will pull the wool over the eyes of millions of Americans holding life and annuity contracts," by making the insurers' capital bases appear plumper than they otherwise would.

But the ACLI disputes that the changes would put consumers at peril. The rules at issue, it says, are overly conservative -- and in one instance all it asked was to begin using early a new rule that was set to kick in later in 2009. In a December report, Moody's Investors Service agreed in part, noting there is an economic cost to insurers "to maintain the very conservative 'redundant' regulatory reserves required" for some policies.

The ACLI also contends the conservatism could boomerang to hurt consumers: If reported capital levels decline, it could cause some people to hastily cancel policies, with adverse financial consequences, while they also could end up hurt if insurers raise new money on punishing terms.

Much of the critics' displeasure has been over the NAIC's fast-tracking of the proposals. "It is disturbing that the NAIC has made no showing of what constitutes 'redundant' or 'excess' reserves overall," the two consumer groups wrote. They added that the current economic upheaval may well be undermining the industry's long-standing conservatism "in completely unknown ways."

In rejecting the ACLI proposals, the NAIC said some of them had merit, and promised that their future consideration would follow the group's "open, transparent and deliberative process."

How many insurers have asked for and gotten relief?

We don't know that yet. To help the public better monitor what's going on, the NAIC says it will assemble data from the disclosures that insurers are required to make in their 2008 state filings.

Some requests have surfaced as publicly traded insurers responded to questions from analysts in fourth-

quarter conference calls or in filings with the Securities and Exchange Commission. One of the biggest requests, and most detailed explanations, came from Hartford. In a Feb. 12 SEC filing, it said Connecticut regulators had approved its use of two items that the NAIC technical experts had cleared, with relief totaling \$987 million. Hartford said this boosted the capital base of its life-insurance units by about 20%, to \$6.05 billion, as of Dec. 31.

In Illinois, Allstate said it obtained \$1.61 billion in relief for two units; that represents about 12% of their capital. Philadelphia-based Lincoln won approval from regulators in Indiana, where a big unit is based, for easing it said totals about \$300 million.

Some non-publicly traded insurers also have obtained relief, including [Nationwide Mutual Insurance Co.](#), Northwestern Mutual Life Insurance Co. and Pacific Life Insurance Co. So far, it appears to be mostly life insurers asking for breaks, but some of Allstate's and Nationwide's relief went to car-insurance units.

Why are life insurers harder hit than other insurers?

Insurers of various types have suffered capital-depleting losses in their investment portfolios. Many of the losses have come from bonds and preferred stock of troubled financial firms like Lehman Brothers and Fannie Mae, as well as mortgage-backed securities. Life insurers tend to own longer-term, and thus riskier, bonds than property-casualty insurers, to match policies that aren't payable for years into the future; property-casualty insurers tend to own larger proportions of short-term, very easily traded securities, as customers file claims at any time.

Also, the market's slide has been punishing for some life insurers that are big issuers of variable annuities. These insurers are collecting substantially less in fees tied to money under management, and their liability has soared for the minimum-return guarantees of these retirement-income products. The insurers are subject to reserve and capital requirements to show they can make good on the guarantees.

Are the life insurers seeking help in serious trouble?

The shares of many publicly traded insurers scream that there are problems: Some are down 90% since last spring. Dividends have been slashed.

The major ratings firms have the life-insurance industry on negative outlook, meaning more downgrades than upgrades are expected in coming months. The first wave took place just after the insurers posted big losses for the fourth quarter. "Given the disarray in the credit and capital markets, most insurers' financial flexibility has decreased in the past six months," Standard & Poor's said Thursday, announcing downgrades at 10 companies. With the economy continuing to worsen, insurers' investment portfolios "could experience unprecedented stress in the next 12-18 months," it said.

Still, at least for now, most big insurers remain in categories signifying "strong" financial health. For their part, many insurers say they have ample capital to honor all obligations, but with capital-raising opportunities limited, they felt it prudent to obtain the easing. Northwestern, a triple-A-rated insurer, says some rules are "unduly conservative," so the relief it obtained gives people "a clearer sense of our financial strength." Some say they acted to stay on a level playing field with rivals who obtained relief.

Exactly what kind of relief have insurers sought?

Hartford and Pacific Life, top sellers of variable annuities, obtained relief tied to the calculation of reserves for their minimum-return guarantees. As Hartford noted in its filing, the existing rule ignores some fees paid by annuity owners that can offset the guarantees' ultimate cost. The relief will allow the insurers to factor in a wider range of the fees.

Many insurers -- including Allstate, Hartford, Lincoln, Nationwide, Northwestern, [Principal Financial Group Inc.](#) and U.S. units of [Aviva PLC](#) and [ING Groep NV](#) -- won permission for more-generous treatment of "deferred tax assets" in calculating their capital. These are credits that a company aims to use to offset future taxes. They have value to the extent that the insurer generates a profit in the future and can actually put them to use.

As the NAIC debated, some regulators argued against expanding their use, saying that projecting profits is tough in normal times and perhaps impossible in the current turmoil. The companies, on the other hand, say expanded use provides a more-accurate picture of their financial position.

[Ohio National Financial Services](#) won permission to use updated mortality policies in setting up insurance reserves as well as deferred-tax assets, among other items. It says the changes are "helpful, but not material to our company."

So what's a consumer to do?

The proliferation of relief efforts means that consumers need to be on guard when reviewing financial data on insurers' Web sites and at the NAIC's Consumer Information Source service, says Brendan Bridgeland of the Center for Insurance Research.

The NAIC says it's looking into how it can alert users of its service. As for insurers, mutually owned Northwestern, for one, says it will post a news release about the rule easings it is employing. Officials at several publicly traded insurers note that they generally don't highlight statutory-accounting figures; instead, their Web sites point to SEC filings. Those filings are based on a generally less-conservative type of accounting.

Many consumers rely on ratings firms' assessments of insurers, and the big firms say they are factoring relief items into their analysis. For instance, if two insurers both report "risk-based-capital ratios" of 400%, but one is using rule easings to avoid a decline to 325%, "we would say that company is more weakly capitalized than the other, all other things being equal," says Robert Riegel, a Moody's managing director.

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