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## **Reassessing Insurance Carriers and Products in a New Era**

Lawrence J. Rybka, J.D., CFP

With a group this size I'd like to keep this participative. I think this is a very, very important topic and it's a somber one. You think all of the recommendations that each of you make to your clients are predicated on the carrier paying that promise at some point in the future. So really looking at the health of the carriers is something that the program committee thought would be helpful.

When Phil Harriman introduced me, he talked about our expertise as a broker-dealer who specializes in the insurance area. I think in my presentation, what I hope to do is show you some tools that we've found on the broker-dealer side, or on the investment side, that really help us analyze the insurance products and companies that we sell, and also another way of looking at them, particularly beyond the rating agencies. Phil mentioned our Project Janis that we really launched about this time last year. Janis is the Roman god who looks not only back at history but forward into the future. And as I look at particularly the services that the rating agencies have provided, they are very much backwards looking and telling us what caused problems five years ago. But the ratings gave us very little warning about carriers that have since had declines in their ratings.

For a long time, I've made it a personal habit to buy 100 shares in any of the insurance companies that we do business with. Now some might call that overly analytical, some might actually call it sick to do this. When I get that prospectus at the end of the year or the annual report, I'll go through it and I'll read it, particularly if the carrier is one we do a lot of business with. And in the note section, it is amazing how much information you can find out about the carriers that you do business with. I keep it in a yahoo file that I'll show you a little later, yahoo finance. It can track those companies you do business with and, anytime there's something written in the news anywhere about those companies, it comes up at the bottom of the page. So you can find incredible information and keep track of the companies you're doing business with just with a simple account.

One of the things you can see is (we've set this up with the columns), what's the 36-month, how much has it moved. Anybody who gives me a business card at the end, I will actually send you the file that you can just install on your internet connection. You can either keep all the companies I've got or you could add other ones that you want to track. But I think it's been a very, very useful starting place for just knowing what's going on.

We've also used a lot of the analysts' reports and these are stock analysts who are looking at the insurance companies. And the candor with which they speak about some of the problems is so much greater than anything that I have seen from the rating agencies. So they've become a key source that really is integrated in the material that I'll show you today, but a very, very helpful insight in looking at the companies you're doing business with.

With that setup, I'd like to talk about my worst investment portfolio and it was 100 shares of all these insurance companies that I bought. Some of them I got in stock options, some of them I

had 10 years, but it forced me to pay attention. I get that brokerage statement on my Quicken. I dial in there and the stocks in the insurance companies started dropping in 2007. Phil Harriman and one of the young insurance analysts in our office co-authored a paper in *Practical Estate Planning* on this very subject looking at stock metrics as at least an early warning sign, or a canary in the mine. If the investors are selling and are worried about the future profitability of the company, it doesn't necessarily mean the company is in trouble, but if they think there's not going to be any dividends or it's really going down, it is at least a warning that you should look.

Two examples from the CCH April 2009 article that Phil and Matt published, example specific, AIG's stock went down 44 percent from February 2008 to the end of May, at the point at which it received its first downgrade. So the stock had declined 44 percent ahead of any downgrades. Another example, Genworth's stock started sliding in the summer of 2007 and lost half of its value by June 2008, before any of the rating agencies made adjustments downward. So the stocks, in looking at what the analysts say, can be a good forward indicator of what might be going on with your company.

The stock analysts really were looking at the problems with the derivatives and subprime mortgages way ahead of the rating agencies.

What are we going to talk about today? We're going to talk really about three things. First, what happened to the U.S. life insurance industry? What has caused these problems? What are the underlying causes? Secondly, which tools can you use to better assess or supplement what you're getting from the rating agencies? Third, and perhaps most important, is what strategies can you employ to really help protect your clients to best assure long-term success of the products that you're recommending. I hope that all three of those will benefit each of you in your practices today.

How big is this problem? Parts of this problem appear right on the surface. We have an insurance company that held Lehman Brothers bonds and Lehman Brothers went out of business. We know that the market value for the bond is zero or whatever, maybe it's worth 5 cents or something like that. That would be a problem we see above the line. Things with subprime mortgages are not quite as visible because they're harder to value. But things like commercial real estate exposure are very, very hard to value because if somebody is not paying the rents on their property to the insurance company, there's no market and mechanism for knowing what that mortgage is worth or what the underlying property would be worth if they had to take it.

How many of you have been in the business 15 years now? All of you. We all remember what happened the last time with Confederation Life and Executive Life and Mutual Benefit and had it not been for AXA Equitable, had it not been for Mass Mutual and Connecticut Mutual and that was all real estate. I think most of us have seen this movie before but we forgot for a while that this could happen. And it doesn't help sales to talk about bad things that may happen, but we have to be aware of them or at least be thinking about what could happen, because that's what our clients are really looking for.

I'd like to put some of this problem in perspective. If you look at the industry as a whole, we've had almost an uninterrupted growth, and this is the capital and surplus of the industry, year after

year. Even in tough years, the surplus grows albeit by a smaller amount because, as the companies take in more and more premium dollars from life insurance and annuities, it adds to surplus. We had a real decline of somewhere between 11 and 17 percent of the capital and surplus that had been accumulated over 150 years. Now with banks, this problem shows up right away. If you lose surplus and I go into my bank and I can write a check tomorrow and take my money out, it shows with a bank right away. With a life insurance company, particularly the products that are being sold now, they're not demand products. They're promises that are 20 or 30 years in the future. So, it bought the industry some time. But the problem is still there and the damage has to be repaired.

Let's look at this another way. Some people say, "Well, this is just happening to a small number of companies" or "My company probably didn't suffer any problems." Seventy of the top 100 carriers suffered a decline in surplus. Only 30 stayed even or had some positive growth in their surplus last year. And I think 2009 is going to be another tough year. Some companies didn't write assets off in 2008 and kept them on their balance sheet. So the whole industry has experienced this problem to varying degrees.

I'd like you to look at this though. We have, if you add this up, 28 and 12, that's 44 companies saw a decline in their surplus of greater than 10 percent. That's significant. And we really owe it to our clients to drill down and look at what caused these things, how much of this problem is visible. What will it mean for policyholders?

I am an undergraduate major in accounting and I sure don't want to get into details of debits and credits on an afternoon in Hawaii because I think I'd put you all to sleep. But it is important to understand broadly what's going on with the income statements and balance sheets of the companies we represent and what caused this loss. We're going to talk a lot about losses of assets, whether it's subprime mortgages, commercial real estate, or bonds that defaulted. All kinds of assets have gone down in value. So that's part of what has caused the problem.

A second part, and this is a little more complex, is operating losses at the carrier level that are caused by product sets that are sold. We had a variable annuity or a secondary guarantee product or maybe very adverse mortality due to premium financing losses or policies that get surrendered. All kinds of things then flow through the income statement of an insurance company in operating losses.

And, finally, something that (unless you read the *Insurance Forum*, Joe Belth's publication) a lot of people are, and I actually am, more concerned about: this third item, more than the first two. We had something happen in the U.S. insurance industry that I think is terrible. For the first time, we allowed political pressure to be brought on state insurance commissioners so we no longer have a uniform standard on how we keep track of things. Nineteen states essentially gave into political pressure from the insurance companies that were in their states and allowed them to account for things differently than the NAIC prescribed. So, in trying to keep track of this it has now gotten much harder because we have all these different permeations on how something might be accounted for. If you're in New York it's one set of rules, if you're in my home state of Ohio, which is one of the states that gave into this pressure, you're accounting for it in a completely different manner.

Let's go to a basic income statement. I have an example here that I wrote out that I'd like to go through. At this point, what does this mean to policyholders. Let's bring this back. It is really the assets of the company that offset or match the promises that the company makes to your policyholders. If the assets get burned up too much or if the liabilities get too big, we could have a situation where there isn't enough money to keep the promises to policyholders. This is why it matters and why it's important to understand this.

When we decrease the value of the asset, capital goes down, but ultimately that capital is the buffer between the promise and the asset of your client. I'd like to talk a little bit, and this is complex, but how separate accounts tie into this because they're technically not on the balance sheet of an insurance company. I use a simple example of a variable annuity.

Let's say that one of you sold \$1 million of variable annuity in 2007, and that the gross dealer concession paid on that variable annuity was 7 percent. Let's also assume that there was a premium tax of 2 percent. So, the insurance company takes in \$1 million that is not on its balance sheet because it's a separate account, but it actually spends or writes a check for \$90,000 because it's paid the commission to you and it's had to pay the premium tax to the state. Well, in accounting they actually put an asset on their balance sheet or else they would go down in value \$90,000. They would lose \$90,000 when they wrote the policy. So they create an asset called a deferred acquisition cost. An asset shows up on their balance sheet for \$90,000. And let's say they charge fees that offset that. So they've got this \$1 million and they charge an asset management expense. They maybe charge a guarantee expense. Let's say the total fees are 3 percent on that annuity. So every year they're going to make \$30,000 of fees from the annuity.

But what happens if the value of the annuity, the assets being invested, goes down to \$700,000 instead of \$1 million? They're going to be able to make less in fees because now the assets are smaller. Well, they have to take a write down on that imaginary asset called the deferred acquisition cost. And normally it gets charged off a little bit per quarter along with the surrender charge. If we have a seven-year surrender charge and we have four quarters, they would drop off \$3,200 per quarter for the surrender charge that is going away and then they would charge their fee.

If the value of the annuity, and let's make it more dramatic, went to \$500,000, they would immediately, in that quarter, have to take a charge for \$45,000 not for \$3,200. That's part of what was happening on the balance sheets of the insurance companies who sold a lot of annuities, this write-off of a deferred acquisition cost. What also happened is some of them with index annuities and with variable annuities had hedging strategies that were based on computer models. Some of the models worked, some of them didn't work. This is an area where the analysts, I think, have done a much better job of talking about how well the companies have or haven't hedged, rather than relying on marketing people from the company to say, "Oh, yes. We hedged this great. We actually made money on our hedges." I want to know what the analysts say, not what the companies say.

Q. ...

A. That may have somewhat to do with that, but it may have more to do now with capital. Now that the companies have burned up so much capital, they are much more concerned about the product mixes, how much they write. Because every time they write an annuity, they have to put up capital to back these promises. I think we see a change in products from just about every company. I think they also found in this stress test that maybe they had been too generous with some of those features and, now in retrospect, they say we really can't afford to offer this guarantee at this price. So everybody, whether it's variable annuities or life insurance products, are all rethinking their product features in today's markets. We've seen, I think, a repricing in just about every business line because of scarcity of capital at the insurance companies.

I'd like to take you through (I'm going to show you some specific companies) just how this might all add up, these different things that we've been talking about.

Let's assume that we have an insurance company, and in my example I think it is a company with \$25 billion of assets and an initial surplus of \$3 billion. Let's assume that, during 2008, the value of those assets declined by 2.5 percent. They had some Lehman Brothers, General Motors bonds. They had a little bit of subprime mortgage. They had some things that just literally went down in value. That's not a big decline to say our assets went down by \$2.5 billion. But if the assets went down by 2.5 percent, that's actually \$600 million of surplus that would have to be written off. Let's assume further that they also had operating losses, because they had mispriced some variable annuities, hadn't hedged very well, had bad mortality on a block of business. They lost \$400 million from operations. And let's assume they paid early in the year, before all of this, \$100 million of payments and dividends to their parent company. Their year-end surplus would be \$1.9 million. You think about that and you think, "Well, that's a decline of about a third or 36 percent."

What we haven't added in on the numbers, and this is where you've really got to dig now, the permitted practices. The hole actually is \$300 million more than what the numbers are showing and what's being reported because this was a retroactive accounting change for 2008. The year is already over and they appealed to the state insurance commissioners to let them change how they accounted for a year that was already over. So it's actually, in this example, a 47 percent decrease in surplus. So small declines in assets or small mispricing in products are leveraged or magnified for the carriers.

How are the rating agencies responding to this? I think the operative word should be responding. Again, they didn't see this coming. It really wasn't until the end of 2008 that the downgrades even started and really accelerated if you look. We actually had a third as many downgrades in 2008 than we have so far in 2009. Again, the rating agencies are responding after the storm has hit. I use the example if we're really looking at the rating agencies to give us a long-range forecast of which companies have financial strength, it's more like tomorrow's weather forecast. They can pretty adequately predict this big hurricane is going to come in and blow down your house, but letting me know tomorrow what's going to happen doesn't give me any comfort.

One of the interesting things is, this time last year, I was invited to present at ACOI. I had never been to that meeting before and it wasn't much bigger than the Top of the Table meeting. It was about 200 insurance company CEOs and chief financial officers. It was a very interesting time to

go to this meeting, because it was literally the first week in October. I don't know if ACOI's meeting is going on right now, but it was right about this point in time, and the financial crisis was just starting to roll through.

I attended the meeting. I did my session. It was interesting to meet some of the people from the companies we work with. One of the most interesting things I observed was, the lunch was sponsored by S&P. The dinner reception was sponsored by AM Best. The name badges were sponsored by Moody's. The rating agencies were the vendors of the insurance companies. I knew that intellectually. But being there and seeing that right while all these ratings are changing made me say, "Boy, this cannot be the only basis for which we look at companies' financial strength. This is just broken."

You also look what is charged. The smartest people who graduate from the best schools don't go to work for AM Best. They're on Wall Street. And when we really look at the money that goes into the analysts trying to look at stocks and dig down deeper, probably by a factor of 10 in terms of talent and money spent on really trying to understand what's going on at the companies, I came to the conclusion that we at least had to look at what the analysts said about these companies, as well as the rating agencies.

Some very, very interesting litigation going on this year with investors who lost significant money in subprime mortgages and sued Moody's rating services. They had somebody from Moody's up on the stand. The plaintiff's attorney is probably grilling this guy: "How could you have called these investments triple A when they were so bad?" And he tried to make a legal argument that, when it got in the papers, just looked very, very silly. There's a term called "puffery." Puffery means if I make a subjective claim about something, if I say my restaurant has the best tasting steaks and they're really terrible steaks, nobody can sue and say those weren't the best tasting steaks. Or you have the most exciting sports car. Claims like that are not actionable.

So this Moody's guy tried to make the argument that saying something was triple A wasn't really saying it was safe, that that was just a marketing term. The SEC has since come in and is now in the process of attempting to regulate the rating agencies, because I think, in retrospect, it has been shown they did such a poor job.

In this, I think a separate case, the federal judge said that this commercial bank which bought a lot of these subprime mortgages and relied on the rating agencies would allow a fraud claim to go forward against Moody's. As a matter of law, this is still an active case so it's not been proven that they committed fraud, but fraud shows intent. That they had to not just miss this, but they actually had to almost be reckless in not looking more carefully.

How many of you have used a Comdex before and know what a Comdex is? If one rating agency is bad, having four of them may be actually much worse. First of all, this Comdex is a black box formula that is very hard to understand. But, if you get it from the company that does Comdex, the ratings trail by about six weeks. So you can be showing your client a Comdex number that is already wrong because the ratings haven't been factored into the new formula. But I'd like to show you just an example of how silly the Comdex rating is.

We have two companies here, Prudential and we have Banner Life. I'd like you just to look at the first two lines of the rating that they have. Both of them have an A+ rating from AM Best, both of them have a AA rating from Standard & Poor's, and the Banner Life Standard & Poor's rating is under review with negative implications. In other words, it's not stable. Now if we just looked at that and said we have two companies that have identical ratings, would we guess that they had a similar Comdex? Actually if you just looked at those ratings you might assume that Prudential would have a better rating because it has a stable rating from Standard & Poor's. The Comdex for Banner Life is 96; the Comdex for Prudential is 87. How does that happen?

Banner doesn't have ratings from these two other rating services so it has the second highest rating here which is weighted at 50 percent. Whereas, Prudential has the second highest rating but lower ratings here and each of them are weighted equally. What's not taken into account is that the ratings may all just change, so if you had a company that had certain ratings in all of them with negative review and another one had the same ratings all being upgraded, they would have the same Comdex score.

Q. ...

A. It's purely formulaic and I think it's relying on flawed data of a flawed system with the rating agencies. This system is broken. And this group can do better than saying to the customers, "Well, here's the price and here's the Comdex rating. I've done my homework." I think this is a call for the real professionals to step up and do a better job. You can go on the computer screen and find that information. It's just bad information and it leads to the wrong conclusions.

Let's get into some of the specific troubled assets. A lot of this information does come from Fitch which, if you look at the overall reports, oftentimes they're better than the individual reports for a company because part of what it does, it puts things in perspective. They might say a company has (and we'll just pick on one here) \$10 billion of subprime mortgages. Is that a lot? Is that a little? Is that good? Is that bad? Who knows? But putting it in the perspective of how much other companies have and what it is relative to their surplus is more useful information.

The white bar here represents subprime exposure (this is a little bit dated information) and the green bar represents [assets] and when you add them together, that's how much exposure to this asset class. We did the calculations and then came back and said well how much of that is their surplus? So going back to my example, if a company loses 2.5 percent of its assets and that causes a \$600 million loss and their surplus is \$3 billion, it's important to look at what that is relative to their surplus? In the example, it would be 20 percent of their surplus.

Now clearly all of these assets are going to be worth something and actually subprime assets have come up in value, certainly since the spring. But this gives you some perspective. I think the subprime story is kind of yesterday's story. Even a company like Genworth, which had tremendous exposure to subprime mortgages, was able to float a new equity offering. They probably wouldn't have been able to do that if the investors were really, really concerned about subprime mortgages as an asset class.

Non-investment-grade bonds. Something not written much about is, there were some really, really good bonds: Lehman Brothers, General Motors, even AIG bonds. A lot of insurance companies held AIG bonds and these were highly rated bonds. Some of them became worthless and a lot of them have been written down. In retrospect, there are a lot of companies that hold bonds that are not worth what they were when they were purchased. That's a second problem asset category: bonds.

Here's both. When we talked about problems you can see and ones that haven't emerged, it's commercial real estate that I think will be a problem of 2010. This is a problem that probably a lot of your best clients have: commercial real estate. Or maybe they lease significant amounts of space from somebody who is holding paper. Our building, which we own, we borrowed \$5 million from AEGON to finance. Now, we're 100 percent leased up. That's one of the good commercial mortgages. But it's hard to value those mortgages. A bond trader could tell you what a Lehman Brothers bond is worth very accurately, but it is very hard to know the mortgage that AEGON is carrying on its books for \$5 million for our building versus the one maybe across the street where they've lost three tenants and maybe the property owner is still making the mortgage payments but he's only got a limited amount of money before he runs through his reserves. It may look like it's still making payments and there's no problem, but it's just one payment away from going into a default.

You would think after the last thing we went through, with all those insurance companies that got into trouble with commercial mortgages, that we would have learned our lesson. I think both with insurance professionals and agents, we just had a short memory. Some of the companies got into the same problem we were in before.

I talked before about variable annuities. This is a problem that clearly hit the financials of certain insurance companies very, very hard, back when the Dow was at 6,500 and they were writing down these losses and they had losses due to hedging and stocks that had big exposure to variable annuities. By the way, I'm jumping around a little bit here.

The insurance industry has always been a relatively stable industry. But if you look at the insurance company stocks now, they've got a volatility or a beta that is about 2.5 or even three times greater than the market. They're some of the most volatile stocks that you can see. If you had the guts to say, "I think the insurance industry is going to make it through this," and you bought some of the insurance companies' stock, you could have bought Phoenix at 20 cents. I think it's at \$3.50. You could have bought Genworth at, I think, \$1.70 and it's up to \$22. All of them have just had a tremendous bounce, 10- and even 15-fold increases. But a lot of it is because the value of the equities has come up and that giant hole, that looked like it might have been there because of the variable annuities, has been solved at least temporarily as long as asset values stay high.

Q. ...

A. I haven't heard any that said, "Boy, we're really not doing great." None of them would say. They all say we're doing great when you ask them. If you read what the analyst would say, some of them would say they did well and some not so well. It's primarily derivatives. You would buy

derivatives that, if the value of broad market indices went down, the value of your derivatives would go way up. The gains on your derivatives offset are held to cover the difference between what might come out of the policy and the guarantee.

A couple of specific questions we ask our carriers on this. If you hear: “We have reinsured this,” that’s a bad answer. Because whoever they reinsured this with is probably smaller than they are and everybody reinsured this with the same reinsurer. An answer of reinsurance may be more of an accounting trick because some of the reinsurance is actually with offshore subs that they own. So you really have to ask very detailed questions about who they reinsured with and that’s usually not a good answer.

A good answer would be: “We have backed this with derivatives.” And, if it’s a public company, the analysts will opine on how those derivatives have actually performed and it will show up in a charge to earnings if there’s a gap. That was a big focus of the analysts with primarily those companies that had big blocks. We’re talking here some of them, the biggest, over \$100 billion. This dwarfs the total asset size in terms of what’s off the balance sheet. So really understanding with these companies particularly what’s going on with their annuities and getting something in writing is important.

Q. ...

A. The sub account for Pacific Life? PIMCO. I don’t know. I’m talking about variable annuities.

One of the interesting things that caused the difference in how the companies structure their products, and they’re all changing, some companies allowed a fairly wide degree of latitude in what you could invest in and still would provide a guarantee. In retrospect, that is hard to hedge because if you have, let’s say, a lifestyle fund and they know exactly what is in there, then it’s easier to buy derivatives that match it. But if Phil can pick what he wants to invest in and he puts most of the money internationally, how do I hedge what he has versus what maybe Wayne has in his account. So I think now we see with the product redesigns they’re really making, if you want the guarantees, you’ve got to keep it in this bucket, because it allows them to better hedge that bucket.

I told you one of the things that concerned me most was not the loss on assets or some of the liabilities, but this very under-reported story. How many of you are aware of the accounting forbearances? This is a really technical topic. We’ve got Top of the Table producers here. Anybody aware of this issue or read about this issue prior to today? We’ve got the smartest people in our business. Companies sure weren’t going to tell us about this.

What happened at the end of 2008 the ACOI went to the NAIC and said, “Man, this is just really, really bad. If we write down these assets the way we’re required to and we set up additional reserves for some of these guarantees based on where the assets’ value are, it’s just going to slaughter our balance sheets. Give us a break. We have these nine things we want to change in the rules for 2008.” Remember we’re talking about the beginning of 2009. And in a closed-door meeting of the NAIC some states, notably New York, said, “No, no. We set up these rules for times like this to be conservative. We are not going to change, retroactively, the rules.” So the

meeting broke up and 44 individual companies went to their states and lobbied for and got surplus relief. They changed the rules retroactively.

So if I'm looking at a carrier in Minnesota and a carrier in Ohio that have the exact same issues, the carrier in Ohio is going to now appear much stronger because of surplus relief. Now it has made it impossible or much harder for the rating agencies and everything to really know and measure things because we're accounting for it differently in 19 different states. And on those nine things, there are different permeations of what each state has permitted. I think it is terrible and may accelerate the point in time when we lose state regulation of insurance because they gave into this political pressure.

Q. ...

A. I have not seen that as maybe an issue but not one that I have researched. I know letters of credit to fund particularly guaranteed universal life contracts is a major issue. But that's a significant issue.

Q. ...

A. I have not seen any of the analysts talk about that either.

Q. ...

A. If you've got something, I'd love to see it.

Q. ...

A. Margins.

Q. ...

A. No, this was not one of the accounting forbearances. It might be. I'm going to talk about gap versus statutory accounting after this slide.

Actually is the next slide. There are two sets of accounting treatment. Statutory accounting is the accounting that you use with the state insurance commissioner. You turn in certain numbers and keep track of things certain ways. Gap accounting is generally accepted accounting principles, which all of the public companies have to use. They still turn in statutory books to the state insurance department, but they have to report their earnings on a gap basis, and there are fairly wide disparities between those numbers. So part of what we've done is look at the difference between these. It helps highlight some of the issues that we really need to look at. The variable annuities are treated very differently under gap and statutory accounting. Even assets. With statutory accounting, by and large, you carry them. This might get to that point, the value of an asset for which you purchased it. So if you put \$100 million into an asset, unless it's actually written down or goes into default, you continue to carry that at \$100 million. Whereas, under

gap, you have to write it down to its market value. That is why you see a big difference between the gap earnings and the statutory earnings.

A lot of the mutual companies may only have statutory accounting that they would release so we have less information about the mutuals than we do about the stocks. I would also say that I think, if you have a stock analyst really severely criticize an insurance company in their analyst's report and the stock goes way, way down, the rating agencies are almost forced to do something or at least acknowledge something is going on. So those quarterly reports and 8Ks that are released with public companies, I think, have forced rating declines, first at the stock companies. And it will be some of the mutual companies that come later.

Q. ...

A. I'll give you an example, a mark to market. We talk with statutory accounting. I buy an AIG bond and I'm Night Life of Texas. I have \$100 million of AIG bonds and I keep on my balance sheet, as an asset, a bond worth \$100 million. At the end of 2008, I can keep that value at \$100 million and I don't have to mark it down or take a charge to earnings on statutory accounting. It's worth \$100 million until the point it becomes essentially in default and then maybe I'd have to write it all the way down to zero.

One of the aftermaths of Enron is they had all these assets that they paid ridiculous prices for. The accountant said, "We should mark to market, or change the value, of assets as they go down, because if the value of the asset is worth less, we shouldn't continue to carry it at that \$100 million." So, if we have a public life insurance company and it bought that AIG bond, at the end of 2008, it had to mark what the actual market was for that bond. And with a bond, we could easily ascertain what that is because the bond would be traded. So if the bond was worth \$80 million instead of \$100 million, then we'd have to carry on our balance sheet for \$80 million, the balance of that bond. So we'd be seeing the problem sooner with a generally accepted accounting principle than you would with a statutory accounting principle.

Q. ...

A. Well, they're only forced for reserve point to follow statutory accounting because it's the state insurance commissioner who says you have to count the reserve for this. So with the variable annuities, they had to increase their reserves when the value of the assets went down because, going back to our example, of the \$1 million annuity. You have a \$1 million annuity. We promised the client 6 percent income for lifetime. We've got this \$1 million bucket of money to pull it from. But when the value of the annuity goes down to \$500,000, we still have a promise to pay 6.5 percent of the \$1 million. Then we have to set up an additional reserve to cover that because the asset is smaller and we still have the liability to the client.

Q. ...

A. Are you talking about the permitted practices from the states?

Q. I think he's referring to the change that was given to the banks versus what you're saying happened in May about a month later, would be accounting forbearance.

A. When we're talking about the accounting forbearances, these apply to stocks and mutuals, because this was something that the Ohio insurance commissioner or the North Dakota insurance commissioner or the Illinois insurance commissioner said or Wisconsin insurance commissioner. Little known fact, but Northwestern Mutual took \$1.5 billion of surplus relief. So their numbers if they were in New York would look \$1.5 billion different on their surplus, but Wisconsin allowed them to change the accounting principles.

Again, at \$1.5 billion for Northwestern Mutual (it's a very large company) didn't make the top 10 of companies that would have been less than 10 percent of their surplus. But these are the top 10 companies in terms of impact on surplus just because of the accounting change. This is solely due to a change in accounting, none of the other things that we just talked about, the subprime mortgages, the bonds, the annuity guarantees. This is just difference in accounting treatment.

Q. ...

A. Yes, right.

Q. ...

A. They did. That's what makes it so hard. Now we have different sets of accounting and we can no longer compare the numbers. It's terrible. And then again, I asked how many people in this room knew about this and you're the best people in the insurance business. I don't want to say this was hidden, but it sure wasn't written much about.

Q. ...

A. Yes.

Q. ...

A. Exactly. One of the conclusions we've come to and I don't want to skip to the end, is saying, "I do business with 20 companies and I know them all," is impossible. I think we're coming to the conclusion that it's better to do business with a smaller number of companies and ask hard questions and really dig. And I'll show you some of the tools. I don't want to run out of time on the tools because I think that will be some of the most valuable things we show you.

I talked a little bit about this already. We have different levels of not only financial strength, or perceived financial strength, but different levels of information. Let's look at a company like Phoenix. The news has been pretty bad on Phoenix, but you can see all of the news. Every quarter they come out with earnings statements. Anytime there are lawsuits it shows right up at the bottom of that Yahoo bar. If the analysts are saying sell Phoenix, you can see that. If we have a mutual company, we know a lot less. Now, in between those, we have these companies that are foreign owned. I'll pick on AXA, a good company. But AXA actually trades on the French

exchange. So you can see what's happening to the stock, but you really can't see down through into the U.S. company what is going on. So we have more information than we would in the case of a mutual, but not as much as we would with a U.S. stock.

Tools. What are we using? Annual reports and the 8Ks. Again, with this Yahoo bar, every time there's an 8K or an event, you see it. I set mine so if the stock moves more than 5 percent or one stock goes down and all the other ones go up, I just glance at it and say was there an announcement today?

One particular company had its reinsurance treaty renewed and the stock went up 25 percent that day. Now that says to me that some pretty smart investors were concerned that the reinsurance treaty might not be renewed at all. I'm reading into it a little bit, but that was material news.

The analysts' commentary. With a good one, there will be 20 to 30 pages and they talk about the annuity reserves, how they're doing on mortality, the reinsurance treaties, the ability to raise capital, all of those things in much greater depth and candor than you will see from any of the rating agencies.

Another tool that we use that is just a real easy one is a price-to-book ratio. We take the book value of the company, what it says its assets are worth and then what the market is trading that stock at. There is wide disparity. If the price-to-book is really low, the market is essentially saying this company, we don't believe the assets that they're saying that they have are really there. Or they're saying this company is worth a lot more dead than alive.

And finally, debt terms for the debt offering. Part of what you see in the news reports is the companies are rebuilding their balance sheets now and their ability to raise new equity or debt and what the terms are.

So let's put this together in an example. These are three actual companies, I won't use names because we're recorded here. Company A has a price-to-book ratio of \$1.28, so the market is valuing it as an ongoing enterprise for more than its book value. It held 68 percent of its value from the 52-week high, so it came down but not very much, and it was able to float \$1 billion of new debt at 4.65 percent.

The second company, kind of a middle company, 57 cents of book. It's come down two-thirds so it's trading at about a third of what it was from its 52-week high and it issued \$1 billion of debt at 9 percent.

Company C is at eight cents of book value. It's dropped 95 percent of its value and it can't issue new debt or equity.

This is additional information that you can use to assess companies.

To simplify this a little bit, and actually it was Denny who is part of our advisory group who suggested this, we put companies into four tiers. Now everything we do we talk about a tier one, two, three or four company. And the rating agencies are still one part of what we look at. We

also look at whether the ratings are stable. If they're all under review, how much weight do we want to put on that? We also look at how many downgrades have there been and whether they are still happening. We look at exposure to troubled assets. How much commercial real estate? Also are they a market leader in product sets that are profitable? If they are, that's a tier one company. They have high price-to-book ratios. They've raised new capital on reasonable terms.

Tier two, solid AA ratings, the ratings are stable. There are still some unresolved issues, but they're not huge ones. They've got a medium price-to-book ratio, maybe 70 to 80 cents price-to-book. They've raised capital already. They've shown in the market that investors are willing to put \$500 to \$700 million in. Smart investors.

Tier three is AA- to A, continued trouble and concerns about assets. A low price-to-book ratio, inability, or maybe an offering is in the works but they haven't done it yet, to raise new capital.

Then tier fours are ones that I think unless something happens, I would have concerns about. So the ratings are continuing to drop. They have multiple problems and here's one of the things that is different this time than 15 years ago. There are no companies to buy the troubled companies. We would have had a whole bunch more failures 15 years ago had not Mass Mutual, Met Life, AXA stepped in. There are no buyers this time. That is a sobering thought.

What are the carriers doing? They're raising new capital. They're issuing new debt. They have cut their expenses. Some companies have made just unbelievable cuts in expenses down to the bone. They've adjusted policyholder benefits to cut dividends or changed COIs. And they're now selling less surplus-intensive products.

Q. You would include in cuts to expenses, changes in commission schedules?

A. I haven't seen too much of that yet. Minor. Because it's a competitive market.

This is another interesting slide that just illustrates my point about there being no buyers. The big circles represent the market cap of the companies before the decline. The green circles represent the current market cap. It just got all sorted and everybody is smaller, essentially.

What does this mean to policyholders? Really it depends on the type of product they have, whether it's a general account or separate account. One thing Joseph Belth talked about was we're probably going to see the sale of blocks of business, not companies as a whole. So companies that maybe got scared about variable annuities will sell that block to somebody else, because they don't want to be in that business anymore. So we will see sales of blocks of business. Unfortunately, I do think we'll see receivership of some of the most damaged companies. That is unfortunate, but I think that's probably what we're going to see.

There was another insurance crisis at the turn of the last century and there was a commission established to look at how we might keep this from happening again? It was called the Armstrong Commission. One of the primary findings of the Armstrong Commission was that the purpose of regulation was to make sure that insurance companies did not charge too little. Because market forces would assure they did not charge too much. And that sounds silly to us,

but I think we've gone through kind of a fire drill with the market going way down and some companies being on the brink, or hovering on the brink, where there was a real question. And it's time for us to think about this. Just saying, "Oh, this is the lowest price. You should buy it." That's not being a professional. It's really not thinking about this transaction as deeply as I know each of you are capable of doing.

I think we really have to look at products that maybe we've ignored for a while like whole life. It's so easy to say, "Oh, this premium is the cheapest." But what happens if you don't have the money to pay the premium and you've got to skip it? How well does that work for the client? Or what happens if, 10 years in, the client's needs change and it essentially becomes a term policy that they paid 10 years and could get nothing for. This group, more than any other, is capable. You're great salespeople. I think of my own group. We've lost some of that skill because we've just fallen into this trap of a spreadsheet. Here are nine companies and here are their Comdex ratings. We're better than that. Being an insurance professional, I think, there's a great opportunity to get back to some of the skills. Here's why this is more expensive and here's why I recommend you look at it.

One thing I'm not going to have too much time to get into, but just to look at, is five different kinds of products. What we started doing is saying, "You can't just look at the numbers because some of this number is guaranteed. Some of it will happen and it's guaranteed. Some of it's subject to company discretion, whether it's a cost of insurance or current interest rate. And some of it is due to a pure market force. If the assets go up 8 percent, you will get X amount of it because it's locked down in this prospectus what the company can charge." And helping customers understand the different products have different combinations of guarantees, company discretion and market performance. I think if we make that simple and try to objectively lay out the choices and the advantage of this and the advantage of this, and what this group can do. The P&C agent who's trying to quote this, with a spreadsheet that somebody else created, can't do that.

There's a great opportunity for the people in this room to again raise the standard to what all of you were taught to do in the business.

How about some strategies? One huge, huge strategy is diversifying. We used to do that after the Confed and Mutual Benefit thing. We'd say, "Hey, would you put all of your entire estate into a single bond? It's a zero bond and won't be due for 40 years." Would anybody on the investment side ever recommend something that silly? That's exactly what we've done with life insurance. Would we say, "This price is a little lower. Let's put all of the money into this and buy \$40 million of coverage with this issuer," if we're really going to do the best? For my insurance I have my coverage diversified with three carriers. It also allows us, if the settlement market ever did come back, we've got three policies we might be able to settle or drop one. It just makes sense.

I urge you to look again. Might sound crazy, but it's separate accounts with guarantees. Today the guarantees on the variable life contracts are as good as, or better than, the general account products. Why not have the lifetime premium guarantee, cash value and separate account protection? If the price is the same or close, why not at least look at it?

Our firm is using life insurance policy management statements under the Uniform Prudent Investment rule. A trustee's sole test of whether he's done his duty is whether he's followed the Uniform Prudent Investment Act. And it requires a written statement that says how we ended up with this conclusion. So, one of the things we're doing is life insurance policy management statements that recommend that we diversify the coverage, that we talk about time horizon, that we talk about budgets and all of those things that document why we recommended and what we recommended.

Another thing, and this again came from our advisory board and particularly Denny, we're talking about this dilemma: what do you do other than a spreadsheet? Because everybody says, "Well, here's 12 to 15 numbers." And Denny said we shouldn't just measure two things, we should measure a lot of things. Premium is one of them, but we should be measuring financial strength a number of different ways. We should be measuring: how likely we are to get underwriting and ongoing service; how well that company has done on the NAIC complaint ratio; product specifications; how easy it is to skip premium; how does their policy catchup provision work; how much cash value there is. We just completely ignore that. And how about contractual features that are relevant to that customer? By bringing in this kind of analysis and saying, "I've looked at three or four carriers and here's why I recommend this one," I think is a much better way to look at life insurance contracts.

Q. ...

A. I'm glad to give each of you a sample of this in hard copy. So, again, if you want one of these, give me your business card. They're waving me on here.

I'm just going to finish with one more thought, and I borrowed this from Dick Weber (give credit where credit is due), an old session. He brought out a quote from the 1800s that was one of the best things that I ever heard.

It was John Ruskin in a book, "The Law of Business." He lived from 1819 through 1900 and he said:

"There's hardly anything in this world that someone cannot make a little worse and sell a little cheaper. The people who consider price alone are that person's lawful prey.

"It is unwise to pay too much, but it is also unwise to pay too little. When you pay too much, you lose a little money and that is all. When you pay too little, sometimes you lose everything because the thing you bought wasn't capable of doing the thing you bought it to do.

"The common law of business balance prohibits paying a little and getting a lot. It cannot be done. If you deal with the lowest bidder it is best to add something for the risk that you run and, if you do that, you will have had enough to pay for something better."

Profound and still true 100 years later. I'm going to wrap up here and if some of you have questions I can answer them individually so we clear the room.

But a couple things that I have offered. We'll go back to them and staying within the bounds of copyrights, this article in CCH that Phil and Matt Severs published on using stock indicators. This template that I promised from Yahoo. We'll send you the file electronically, just paste it right in your browser and you'll be automatically set up. That's what they have to do for me. And then if you want to see our carrier snapshot and the things we're looking at beyond price and Comdex ratings, I'd be glad to send that to you as well. Thank you.

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