MEMORANDUM

M Financial Group™

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To: M Financial Group Member Firms

From: Fred Jonske, President & CEO of M Financial Group

Date: October 10, 2008

RE: **The Recent Decline of Life Insurance Stock Prices**

There have been a number of headlines in recent days warning that life insurers may be the next to be swept up by the crisis crippling the world markets. With the stocks of major life carriers—including M Carriers—down dramatically, it is clear that fear and an overall lack of confidence in our financial markets are ruling each trading day.

You and your clients are understandably concerned by recent events with these stocks. It is natural to think if a life insurer's stock price has dropped 40% in a week that the contract you hold may be in jeopardy. However, it is important to distinguish between the interests of stockholders and policyholders.

Stockholders, which have suffered through a week in which life insurance stocks have plunged an average of 30%, are focused on the future earnings of insurance companies. Price declines across life insurance stocks reflect that the markets expect higher capital costs and declining investment portfolio returns to erode the earnings that shareholders can expect to receive. A declining stock price does not directly impact the operations of the company with respect to policyholders. However, it indirectly impacts the amount and cost of capital that a company could raise should the need arise.

Policyholders are focused on solvency: a life insurer's ability to honor the contract in place and pay a claim if submitted. Again, a declining stock price does not directly impact a carrier's solvency. Due to a well established regulatory infrastructure, that includes stringent reserve requirements—funds that can be used only for paying claims on policies issued by the company—policyholders have a level of protection that may provide meaningful comfort in volatile times.

To look at it a bit differently, when you buy insurance you are not buying the stock of the insurance company, you are buying an asset that is subject to strict regulations designed to protect policyholders. As a result, life insurance policies may be viewed by some as a safer port in the current financial storm.

There is lingering concern, however, regarding the impact of the broader market declines on life insurance investment portfolios, as well as the liquidity of the assets in these portfolios. Douglas L. Meyer, an insurance analyst at Fitch Ratings, commented: "Insurance companies tend to focus on high-quality investments." When the declines were mainly in the lower-quality investments, he said, the industry was relatively sheltered from harm. Now, though, "the depths of the current credit crunch are starting to affect the high-grade securities, so that's starting to affect the insurance companies more."

In addition to Fitch, Moody's, Standard & Poor's, and AM Best have put the US life insurance sector on negative watch, implying that carriers may need to raise capital to offset investment losses. These announcements are reflective of the uncertain direction of the current crisis. However, the write downs insurers have taken in response to the crisis—to date—have been within available capital and surplus.

For now, insurance company analysts, including Colin Devine of Citigroup, do not see an insolvency risk. On Friday, October 10, Mr. Devine, who covers all six of the publically traded M Partner Carriers, issued a report stating “Sale of Life Insurance Stocks Vastly Overdone: Do Not Believe Any Names within Our Universe Face Insolvency.” Highlights from the report are noted below. As a reminder, Mr. Devine will be a featured speaker at the M Principals Forum in San Francisco on Thursday, October 30.

One final note: it is important for policyholders to remember that the AIG situation does not involve an impairment of the life insurance operations. AIG’s troubles stem from a non-insurance entity, AIG’s Financial Products subsidiary, that was issuing credit protection products. These products have suffered huge losses due to the current credit crisis. These are losses of shareholder value, not policyholder value. The assets within AIG’s life subsidiary are protected by regulation for the benefit of the life subsidiary and are sufficient to meet the life subsidiary’s liabilities.

These are unprecedented times and things can change at any moment. As our government tries to restore confidence, and volatility continues, we learn more each day. We will continue to monitor developments, engage our Carriers in conversations, and focus on supporting your business. Take pride in the products, services, and guidance you provide to clients at this critical time for our nation. I welcome your feedback. Please contact me with questions and comments at 503.414.7500.

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Colin Devine
Managing Director
Citigroup Investment Research
<u>Citigroup Investment Research: October 10, 2008</u>

Do Not Believe Any Names within Our Universe Face Insolvency

- **Key Takeaway(s) -** Despite the intense sell-off of life insurance stocks over the past week none of the companies within our universe face the type of financial stress that caused the problems of AIG. That said, in the wake of the damage that has been done we anticipate a wave of M&A activity and look for the group to emulate the rapid consolidation that has occurred in the bank sector.
- **Now anticipate a host of capital raises -** We had expected GNW might have to raise capital because of its trouble MI business and that PRU could need some because of potential sub-prime MBS and other investment losses. But, it now seems most insurers will be compelled by the market to follow the lead of MET and HIG and raise external capital. We anticipate: PFG, LNC, AMP, AFL, PRU and GNW may all elect to issue capital in order to restore investor confidence.
- **Life insurers can't have a run on the bank -** Lack of liquidity was a clear problem for AIG as its need to borrow from the government demonstrates. By comparison, we estimate less than 2% of the typical life insurer's liabilities can be readily surrendered without penalty. The life industry learned its liquidity lesson back in 1992/93 with the collapse of several large insurers. Ever since then the rating agencies have enforced rigid liquidity models.
- **Unrealized losses are not necessarily an economic threat -** A vital distinction between life insurers and other types of financial services companies is that they do not have liquid liabilities. They not only have the intent to hold their fixed income securities to maturity but also the ability to do so. As such, unrealized losses due to movements in credit spreads or interest rates will not necessarily become realized if the underlying cash flows are not impaired.
- **M&A might help put a floor on valuations -** We would speculate the pending sale of AIG's U.S. life insurance, annuity and group pension businesses as well as its international operations might help to bring some buying interest back into the life sector, much has happened for banking following Wells Fargo's bid for Wachovia. We would identify MFC and MET as the two most likely bidders. Other potential names that still possess the valuation strength and excess capital to be buyers include SLF and GWO, whereas we would not be surprised if LNC, PFG or AMP emerged as sellers.