Research Note

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Insurance Industry Note
Freeman & Co. LLC

Converging Issues for U.S. Insurers

Today there are two concurrent and significant issues that are impacting U.S. insurers' financial positions. These issues will likely lead to increased M&A activity, particularly in the form of divestitures from some large U.S. life carriers:

1. Book value and earnings hits are forthcoming due to a pending accounting change to deferred acquisition costs ("DAC")

2. Pending regulatory rules may cause thrift holding companies, which are often run by insurers, to be subject to bank holding company ("BHC") reporting requirements

There are multiple insurance companies that are likely to be affected by both of these changes. We believe that one of the ways that these particular firms are likely to solve these issues will be through divestitures of their thrift units and/or other non-core assets to avoid BHC requirements and to raise overall levels of capital.

While DAC accounting will impact book values of U.S. life insurers, Solvency II capital requirements will affect European insurers and their U.S. subsidiaries.

Larger U.S. carriers may raise additional capital in response to these issues, however, we expect both the trend and the pace of divestitures to increase across several non-core lines.

** Recent completed or announced divestitures:*

- Allstate – possible divestiture of Allstate Bank NA (plans to cancel bank charter by 2012)
- Guardian – terminating deposit insurance coverage
- Hartford – seeking to divest Federal Trust Corp
- ING – selling U.S. online bank to CapitalOne
- Lincoln – sold deposits of Newton Country Savings & Loan to Wolcott Bancorp
- Metlife – seeking divestiture of mortgage business and exploring sale of MetLife Bank NA
- Nationwide – considering options for thrift subsidiary
- Prudential – sold Prudential Bache Commodities brokerage to Jefferies

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Issue 1: DAC Accounting

As the result of a task force initiated in late 2009, the Financial Accounting Standards Board ("FASB") has begun to implement accounting treatment changes for deferred acquisition costs – costs associated with selling insurance contracts (see *FASB Accounting Standards Update 2010-26*). The new rules stipulate that sales costs may be capitalized for successful policy acquisitions, and firms will no longer be able to capitalize the costs of unsuccessful sales efforts. The FASB, in conjunction with the SEC, enacted the changes because insurance companies were capitalizing a broad assortment of costs which differed greatly from company to company under the previous rules. As a result of the impending changes, many insurance companies will soon experience a hit to their book value due to a write down of DAC intangible assets. In addition, policy acquisition costs will rise in the near-term as they will no longer be spread over future years as they had previously been allocated. Firms will be faced with the choice of adjusting their GAAP financials in a retroactive or prospective manner; however, it is anticipated that most firms will choose to adjust retroactively. The impact to insurer's financials will be significant – according to recent research by Citigroup, many firms will experience write downs to book value on average of approximately 10% for a select universe of 11 large insurers that were studied.

Company	DAC	Shareholders Equity Ex. OCI	% of Common S/E Excluding OCI DAC
AFLAC Corp.	10,028	10,434	96%
Allstate Life Ins. Co.	2,782	5,331	52%
Ameriprise Financial	4,582	9,449	48%
Genworth	7,362	12,370	60%
The Hartford	9,584	21,752	44%
Lincoln National Corp.	7,999	12,473	64%
MetLife, Inc.	17,983	49,953	36%
Principal Financial	3,335	9,161	36%
Prudential Financial	16,563	29,683	56%
StanCorp Financial	295	1,732	17%
Torchmark	3,415	3,627	94%
Unum Group	2,558	8,255	31%
		Average for U.S. Insurers:	53%
		Median for U.S. Insurers:	50%

Source: Citigroup Global Markets Equities Research, except Allstate which is a Freeman & Co. estimate

The severity of the adjustment or write off will depend on product duration and sales costs. High write offs will result from products with high sales costs such as variable annuities, fixed annuities, long term care and individual life. Relatively lower write offs will come from products such as group insurance. These adjustments will not affect a firm's cash flow or statutory accounting, as DAC was not historically accepted in statutory accounting.

Pending finalization of the new regulations, it is anticipated that these accounting changes will be in effect for fiscal years beginning on or after December 15, 2011. Insurers will likely give guidance to the impact of these changes beginning in the upcoming Q3 2011 reporting period.

Issue 2: New Thrift Reporting Rules

The proposed new thrift reporting rules will come into effect on March 31, 2012, and will require thrift holding companies to file the same reports that the Federal Reserve requires of BHCs. This will be a major change for insurance companies that currently own thrifts, as today they are only regulated by states. For some insurers, thrift deposits represent a significant portion of their total assets (see table below).

Thrift Holding Company	Thrift unit
Prudential Financial, Inc.	Prudential Bank & Trust, FSB
Hartford Financial Services Group, Inc.	Federal Trust Bank
Lincoln National Corporation	Newton County Loan & Savings, FSB
Principal Financial Group, Inc.	Principal Bank
Ameriprise Financial, Inc.	Ameriprise Bank, FSB
Mass Mutual Life Insurance Company[1]	MassMutual Trust Company, FSB
Allstate Corporation	Allstate Bank

As of 6/31/2011

(1) As reported by thrift unit in Schedule HC of thrift financial report filed with OTS only in accordance with statutory accounting principles. The rest of the asset sizes listed are in accordance with GAAP.

Source: SNL Financial

The new regulations are still in flux as lobbying continues. Another aspect of the changes is that thrift holding companies could also become subject to the Financial Stability Oversight Council, the body that will be in charge of deeming institutions "systematically significant."

If these new reporting requirements are passed, insurers who own thrifts will have to evaluate the significance of those subsidiaries, potentially leading to divestitures. Some insurance companies acquired thrifts in the wake of the global financial crisis in order to receive TARP assistance, therefore the strategic value of keeping them is debatable.

1) *Citigroup Global Market Equities Research: Beware the ASU 2010-2016 DAC Attack (22 September 2011)*