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DUE CARE BULLETIN

August 2011

Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.

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S&P Downgrade of U.S. Credit Rating: Initial Perspectives

On August 5, 2011, Standard & Poor's Rating Services (S&P) downgraded the long-term credit rating of the United States of America to 'AA+' from 'AAA' and maintained its negative rating outlook. The action came after S&P placed the rating on CreditWatch Negative on July 15, 2011.

According to S&P, the downgrade reflects their opinion that the fiscal plan approved by Congress and signed into law by President Obama falls short of what, in S&P's view, would be necessary to stabilize the government's medium-term debt situation. Additionally, S&P stated that the effectiveness and stability of American policymaking and political institutions have weakened at a time when persistent fiscal and economic challenges have continued to grow.

The Immediate Impact

In addition to the sharp financial market declines around the world, the S&P downgrade of the U.S. sovereign credit rating had an immediate impact on several life insurance companies. Because S&P constrains its financial strength ratings on insurers to the sovereign local-currency credit rating, S&P downgraded the financial strength ratings of the five U.S. insurance groups that held 'AAA' ratings. The affected insurance groups—which now have 'AA+' ratings with an unchanged negative outlook—are Knights of Columbus, New York Life, Northwestern Mutual, Teachers Insurance & Annuity Assoc. of America (TIAA), and United Services Automobile Assoc. (USAA). Additionally, S&P affirmed the 'AA+' ratings on five other insurance groups—Assured Guaranty, Berkshire Hathaway, Guardian, Massachusetts Mutual, and Western & Southern—and revised the rating outlooks on these companies to negative from stable.

In explaining the downgrades, S&P stated that their view of each company's fundamental credit characteristics has not changed as a result of the U.S. sovereign credit downgrade. Instead, the actions reflect their view that the link between the ratings for these insurers and the sovereign rating for the U.S. could lead to a decline in the insurers' financial strength. The five downgraded insurance groups have significant holdings of U.S. Treasury and agency securities—between 60–200 percent of total adjusted capital for each of the five groups at year-end 2010. However, S&P stated that these companies maintain very strong capital and liquidity.

It is important to note that Moody's and Fitch have not taken action to downgrade the U.S. sovereign credit rating. While downgrades remain a possibility, Fitch noted in a statement that the United States' debt ceiling increase was approved, and "commensurate with its 'AAA' rating, the risk of sovereign default remains extremely low."

The NAIC View

In terms of the effect on the mechanisms in place designed to protect policyholders, the National Association of Insurance Commissioners (NAIC) stated the downgrade

S&P Downgrade of U.S. Credit Rating: Initial Perspectives (continued)

will have no direct impact on required regulatory capital for U.S. Treasury and agency securities. Even if regulators assigned a risk factor similar to corporate bonds when determining risk-based capital (RBC) ratio, it is estimated by one analyst that RBC ratios for their covered companies would only decline 7 percent from an average year-end 2010 level of 463 percent. In addition, it is not expected that life insurers will be forced to sell Treasury or agency securities. In a report issued early Monday, August 8, Colin Devine of Citi Investment Research & Analysis, stated: "Japanese life insurers adapted to that country losing its 'AAA' rating and continue to hold large levels of government bonds. We see no reason why U.S. insurers won't do so as well."

Interest Rates

In the Citi report, Colin stated that he expects life insurer shares will remain heavily influenced by the direction of long-term interest rates. If the downgrade creates upward interest rate pressure, "any increase in long-term yields would be positive with respect to both future investment income and liability valuations. It could also, in isolation, potentially be favorable for life insurers' share valuations. Conversely, any decline in equity markets would intensify existing earnings pressures on variable annuity lines and could potentially lead to either higher benefit costs and/or accelerated amortization of deferred acquisition costs (DAC)."

Still Financially Strong(est)

The U.S. Federal Reserve and several foreign central banks have announced that U.S. Treasury and agency debt will continue to be accepted as top-rated collateral. This is due to the fact U.S. Treasuries previously made up approximately 60 percent of the world's highest-rated debt. As a result there simply is not enough 'AAA'-rated debt available in the marketplace, meaning that the U.S. will continue to be the key issuer of the highest quality and most liquid securities available for the short- to medium-term. This will mitigate the impact on banks' ability—in the short term—to extend credit, as required reserves are not impacted by the downgrade.

However, foreign holders of our government debt (especially China, if recent statements are any indication) may seek to diversify into other investments systematically over time. Over the long term it may drive up the cost of capital, which would increase U.S. deficits and slow economic growth. While the impact on short-term rates may be negligible, it is believed that the downgrade may cause long-term interest rates to increase.

The Consensus View

The consensus view on the downgrade is that it was a foregone conclusion and many have already adjusted for it. The downgrade is not the result of any change in the perceived risks and challenges facing our country's financial strength. Instead it is viewed as a "no-confidence" statement in the ability of the Congress and the Administration to achieve a consolidated fiscal plan to address the country's long-term debt and deficit situation. The U.S.'s fiscal condition has not changed, but S&P's faith in the U.S. government's ability to address the situation has deteriorated to the point that it has negatively impacted the nation's credit worthiness.

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August 8, 2011

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