

## Special Comment

# Moody's Insurance

August 3, 2009

## Are Insurers and Investment Managers on the Road to Recovery?

### Table of Contents:

Overview	2
North American Life Insurance	2
North America P&C/Reinsurance	5
U.S. Healthcare Insurance	6
Latin America Insurance	7
European Insurance	8
Asian Insurance	10
Financial Guarantors	12
Managed Investments: Asset Managers	15
Managed Investments: Hedge Funds	17
Managed Investments: Money Market Funds	19

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One of the most frequent questions that investors have been asking Moody's is whether the bottom of the financial crisis has been reached and if the global markets and economy are now on the road to recovery. Most importantly for creditors, related questions are also "What type of road can we expect over the next few quarters?" and "What are the pitfalls that we need to watch out for?"

In order to offer a comprehensive response to these questions, we have put together a global team of senior analysts from each financial sector group, who prepared the recovery roadmap contained in this report, which is part of a broader series on the theme of recovery<sup>1</sup>. In this report, analysts discuss common global trends as well as issues that are specific to a variety of insurance companies (life and property and casualty), reinsurance, health insurance, financial guarantors and mortgage insurers, as well as to investment management entities (asset managers, hedge funds, and money market funds) across North America, Latin America, Europe, and Asia.

We observe that market access for most types of financial institutions in most regions has come a long way from the severe stress of last fall; we also note, however, that most of these firms are still down in the valley of financial challenges and, perhaps more significantly, that no one should consider recent improvements as assurance that the current rebound can be sustained.

<sup>1</sup> See our recently published reports "Are Banks on the Road to Recovery?" (118781) and "Are Corporates on the Road to Recovery?" (118669).



## Are Insurers and Investment Managers on the Road to Recovery?

### Overview

Under our central global economic scenario<sup>2</sup>, we predict a “hook-shaped” recovery path characterized by an upward tilt that lies somewhere in between a U- and an L-shaped economic recovery, implying a painful journey. The difficulty of the recovery has been exemplified by the struggles of insurers and investment managers; macroeconomic indicators – and ratings – may have reached a bottom, but we recognize that the fundamentals of financial institutions are still vulnerable to a number of uncertainties.

Although we do foresee some variations across firms and regions, which we discuss in the sections that follow, the common risks and trends that underpin our overall assessment include the following:

- Recent signs of recovery are largely due to the stabilization of investment markets, which has resulted from broad-based intervention by governments around the world that paved the way for the return of investors' confidence and risk-taking.
- Unlike banks, the bulk of assets held by insurers and investment managers are traded securities that are marked to market. Insurance industry capitalization, which had been dented by realized and unrealized investment losses, is beginning to improve. This follows the recent upswing in the equity and debt markets, as investment portfolios gained value and as many firms rushed to raise capital via debt and equity raises.
- For insurers, these gains could prove to be ephemeral, as market conditions may deteriorate in the near future in response to the negative feedback loop perpetuated as recessionary forces continue to constrain economic growth. However, we note that our ratings are based on the assumption that markets will remain sluggish.
- For most financial guaranty and mortgage insurers, which specialize in protecting against financial losses, the prospects for recovery are tied most directly to improvements in the residential mortgage markets, where the scope of actual and potential losses has pressured overall resources and damaged reputations.
- For managed investment entities, the crucial challenge will be the transition to a world of more restrictive operating guidelines imposed both by market forces and regulatory oversight. These changes will reduce liquidity risk within money market funds while pressuring profit margins and the overall business model.

In the following sections, we assess issues pertaining specifically to insurers and investment managers operating in different parts of the world.

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### North American Life Insurance

Over the first half of 2009, there were a number of developments--both good and bad--affecting the credit of North America life insurers. Of late, these have been mostly positive, but the life insurance industry still faces an uphill battle, and certain companies have clearly benefited more than others. A number of companies took advantage of a thawing in the financial markets to raise significant capital and protect their credit profiles against a downside scenario.

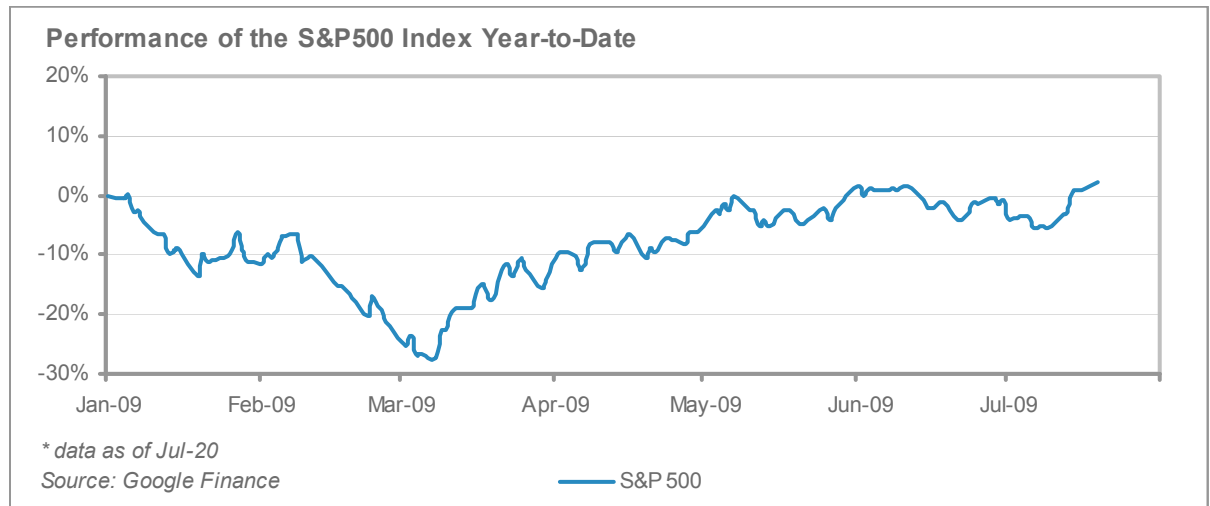
The life industry appears to be on the road to recovery, but the road will be bumpy, as companies continue to contend with volatile equity markets, heightened fixed income impairments, and potentially troubled commercial real estate investments.

<sup>2</sup> See “On the Hook – Update on Moody's Global Macroeconomic Risk Scenarios 2009-2010”, May 2009.

## Are Insurers and Investment Managers on the Road to Recovery?

### Rally in Equity Markets Takes Some Pressure off VA writers

The rise in the equity markets since early March – shown below - clearly takes some pressure off the major VA writers.



However, some VA writers are still coping with older blocks of mispriced or underhedged business. Even with the “derisking” of new VA products recently introduced by most companies, insurers must still contend with the impacts of low interest rates and higher equity volatility on older blocks of VAs, as well as with the long-term uncertainty associated with policyholder behavior.

In order to protect against the potential for onerous regulatory capital requirements in a down equity market scenario, many have added additional hedge positions but usually at the expense of giving up the full benefits of an equity market upswing. This could partially offset some of the financial benefits associated with the recent market appreciation.

### Investment Grade Bond and Commercial Mortgage Defaults Continue

Asset impairments and losses are expected to remain elevated over the remainder of the year, continuing to constrain industry profitability and capital adequacy. The rally in the credit markets in 2Q09 has helped narrow unrealized losses, but our main focus continues to be on ultimate economic losses.

Although the industry has some exposure to below-investment-grade bonds and equities/alternatives, its key exposure is to the performance and default rates of the very substantial portfolios encompassing investment grade bonds and commercial mortgage loans. During the first half of 2009, most insurers experienced substantial credit migration in structured securities (particularly RMBS) and financials, resulting in greater exposure to below investment grade bonds and much higher regulatory capital requirements.

We believe that reported investment losses will continue to slowly drag on throughout 2009 (at 100-200 basis points of invested assets) and continue in 2010, given the steady pressures on most asset classes and the industry's practice of delaying losses until impairments are actually apparent.

### Access to Capital Markets Unfreezes

The recent capital raising by a number of life insurers in the second quarter of 2009 definitely helps mitigate some downward pressure on company's credit profiles under a stress case scenario. The extent of the benefit depends on the following: 1) the form of the capital raise; 2) how capital is deployed; and 3) whether capitalization was seen as a primary weakness.

We note that the opening up of the capital markets has been somewhat selective: it has benefited certain companies perceived to be stronger, while leaving some others challenged to raise cost-effective capital.

## Are Insurers and Investment Managers on the Road to Recovery?

### U.S. Life Insurance Industry Capital Raises

Issuer	Type	Amount (US \$M)	Date
AFLAC	Debt	850	May
Ameriprise	Debt	200	May
Ameriprise	Debt	300	June
Ameriprise	Equity	900	June
Delphi Financial	Equity	51	April
Hartford	TARP	3,400	June
Lincoln	Debt	500	June
Lincoln	Equity	690	July
Lincoln	TARP	950	July
MassMutual	Debt	800	May
MetLife	Debt	1,250	May
MetLife	Hybrid	500	June
PacificLife	Debt	1,000	June
Principal	Debt	750	May
Principal	Equity	1,150	June
Protective	Equity	122	May
Prudential	Debt	1,000	June
Prudential	Equity	1,400	June
Torchmark	Debt	300	June

### Government Support (e.g. TARP CPP) Only Taken by Two

Given the thawing of the capital markets for many insurers in the second quarter of 2009, the majority of insurers eligible to participate in the Treasury Department's Capital Purchase Program (CPP) elected not to participate. Of the six insurers eligible to do so, only Hartford Financial Services Group, Inc, and Lincoln National Corporation elected to become involved.

The receipt of TARP capital improved these companies' overall financial flexibility. Offsetting this benefit, however, is a perceived stigma in the marketplace associated with accepting TARP funds that may hurt the companies' reputations and franchises, as well as the potential for operational conditions and restrictions that accompany the participation in TARP.

To the extent that fresh capital--whether external debt/equity or TARP preferred--materially increases companies' capital and liquidity buffers and/or financial flexibility, we see this as improving credit quality. This in turn would prevent future downgrades and/or allow stabilizing outlooks, which are still currently negative for most of the life companies.

Nevertheless, a capital raise is unlikely to result in rating upgrades. Such an action may fill a company's capital hole and strengthen its balance sheet against a downside scenario, but there are other rating considerations it does not address. For instance, continuing concerns may exist about the insurer's profitability and/or about its risk management or tolerance

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## Are Insurers and Investment Managers on the Road to Recovery?

### North America P&C/Reinsurance

North American Property-Casualty Insurance/Reinsurance remains, for now, among the sectors least affected by the ongoing economic and capital market stress, and downgrades have been modest to date. Property-casualty insurers certainly have experienced some pressure on earnings and capitalization as a result of asset impairments. However, the credit challenges experienced by their insurance and financial service affiliates, and to a lesser degree underwriting losses arising from hurricanes and other natural catastrophes, have been more significant sources of credit strain.

#### Credit Stress Felt Most by Insurers Affiliated With Diversified Groups

Among North American property/casualty insurers and reinsurers, including Bermuda-based groups, the effect of economic and capital market strain on creditworthiness has been relatively modest for pure-play firms within the sector, but the impact has been considerably more pronounced for firms that are part of diversified insurance and financial institution groups.

For example, ratings lowered on property/casualty insurers affiliated with diversified groups – such as Allstate, Hartford, Old Republic, and XL Capital, among others – accounted for approximately 80% of all downgrades in this sector during the past nine months. The downgrades were based primarily on pressures affecting these firms' life insurance, mortgage insurance, and financial and derivative product affiliates, rather than on the performance of the property-casualty operations themselves, which have in most cases remained profitable. That said, we believe that these insurers may be, and in some cases already have been, called upon by their parent companies to support the capital needs of their affiliates.

#### Outlook for U.S. Commercial Lines Insurers Revised to Negative<sup>3</sup>

Our negative outlook for commercial lines insurers reflects a continuing trend of flat to slightly negative pricing across most general casualty business lines, as well as a thinner economic cushion in insurers' claim reserves, and somewhat weakened capital adequacy levels related to a combination of realized/unrealized investment losses and significant 2008 hurricane related losses.

Commercial lines insurers' exposures to claims and defense costs from potential class-action litigation related to directors' and officers' liability and corporate bankruptcies also remains a general concern, but one that will be somewhat limited in both severity, and in scope, in part by Supreme Court decisions in recent years. Personal lines insurers have likewise faced some capital strain from catastrophe and investment-related losses, but these concerns have remained offset by their stronger risk-adjusted capitalization levels, and by more responsive pricing in personal lines.

Reduced business volume arising from lower levels of consumer and business consumption is also likely to remain a general pressure on the sector for the intermediate term.

#### Asset Risk is Moderate, and Liquidity is Robust

Property/casualty insurers' investment portfolio quality varies, and some firms have experienced greater losses on single-name, equity, and structured investments than others. Nevertheless, most insurers' portfolios remain invested predominantly in U.S. government and high-grade municipal, corporate, and government/agency mortgage-backed securities. To date, no stand-alone property/casualty insurer has pursued access to TARP funds or government-backed liquidity facilities, and holding company funding remains overwhelmingly focused on long-term debt, with modest utilization of commercial paper, and manageable levels of financial leverage.

In recent weeks, the thawing of the capital markets have enabled some property/casualty insurers to raise debt capital, but the need for funding has been limited and focused on pre-funding future debt maturities.

<sup>3</sup> U.S. Property & Casualty Commercial Lines Insurance Industry Outlook, March 2009

## Are Insurers and Investment Managers on the Road to Recovery?

### 2009 Hurricane Activity a Key Determinant of Near-term Credit Stability

Given moderate levels of stress on capital and earnings to date, we believe that U.S. property/casualty insurers' and reinsurers' near-term credit strength could depend in part upon the level of hurricane catastrophe losses in 2009. It is unlikely that the absence of large losses will be a strong positive. But firms experiencing outsized losses relative to peers and having difficulty accessing capital markets – which heretofore have been accommodating to insurers' seeking to recapitalize following large loss events – could experience ratings downgrades.

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## U.S. Healthcare Insurance

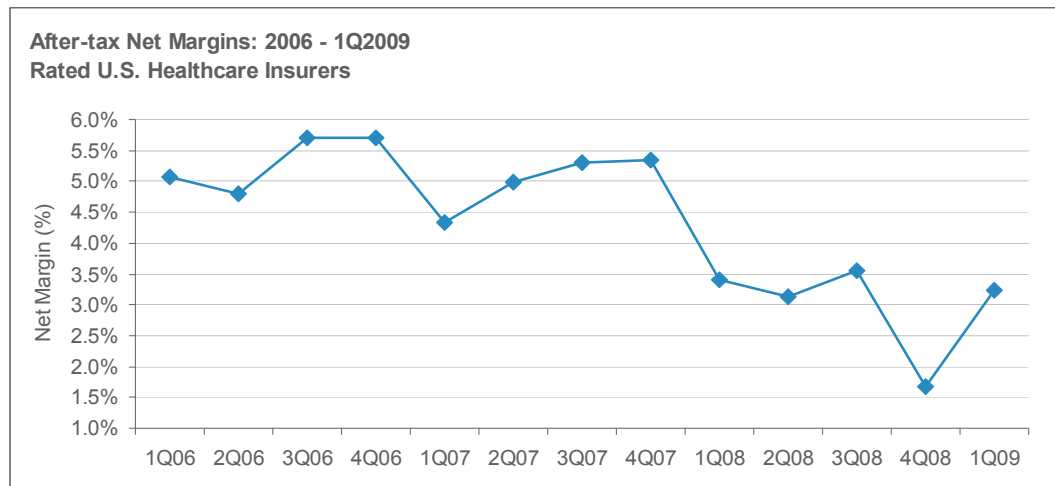
The U.S. Healthcare insurance sector regained some earnings traction in the first half of 2009. Nevertheless, insurers face increasing headwinds as economic conditions continue to hinder membership growth and dampen earnings. Meanwhile, the repercussions of healthcare reform remain unclear, and probably will for some time.

There were very few rating downgrades or upgrades in the first half of 2009. But, given the overall political and economic environments, several healthcare insurers now have negative outlooks.

### Lower Earnings Forecasts Being Hit

By this time last year, we had seen a number of healthcare companies significantly revise their earnings guidance downward for a variety of operating and pricing reasons. As mid-year earnings begin to be reported, healthcare companies, for the most part, are on target with their full-year 2009 projections, although these remain lower than 2007's results.

Commercial membership continues to be pressured as a result of the economic downturn, and the potential exists for membership losses to even exceed the levels projected, which could further dampen earnings.



## Are Insurers and Investment Managers on the Road to Recovery?

### Federal Action Is a Key Risk Factor

The outlook for 2010 indicates that commercial membership will continue to be challenged, but --as a result of lower federal reimbursement levels--Medicare Advantage membership may come under pressure as well.

The other major issue dampening the credit outlook on the sector is the prospect of federal healthcare reform<sup>4</sup>. As Congress begins to release draft healthcare reform legislation, there are several key provisions that have gained significant momentum. We believe that these could have a significantly negative impact on the healthcare insurance sector's creditworthiness. These include 1) a competing government or public plan; 2) mandates at the individual or employer level; and 3) taxation of employee benefits.

Until the details of the reform plan are finalized, it is difficult to determine what the exact impact will be on the sector and on each healthcare company. As we have previously stated<sup>5</sup>, the effect on any particular company will be influenced by a number of internal factors, such as the company's business and financial profiles, as well as management's flexibility to adapt and implement new strategies.

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## Latin America Insurance

Latin American insurers continue to experience moderate strain from the regional impact of macroeconomic stresses, which is consistent with our assumptions embedded in their current ratings. Given the circumstances, however, Mexican insurers will likely experience a somewhat greater impact from earnings strain and business contraction than their Latin American peers.

### Insurance Segments Affected by Regional Credit Stress

Insurers throughout Latin America continue to feel strains related to the regional shock of global economic dislocation. This severe stress has manifested itself in lower market values (higher credit spreads) on their investment portfolios – which are predominantly concentrated in local and national government bonds – and also in a reduced demand for insurance coverage. These shrinkages are occurring in the areas of life insurance, annuities and private pensions, as well as property, automobile, and business insurance – not to mention workers' compensation.

Of course, life insurance premiums and annuity/pension deposits are normally a function of consumer savings, wealth, and disposable income. Nevertheless, demand for general insurance coverage also broadly reflects the overall economy, including employment levels, home values, automobile purchases, construction activity, commercial transport and trade. Essentially all Latin American insurers are thus affected by their country's macroeconomic environment.

### Credit Strain Remains Within Tolerances for Current Ratings

That said, we have taken only modest rating actions on Latin America insurers to date. Furthermore, we expect that future actions will be relatively modest, absent further economic shocks. Our opinion is based on current macroeconomic expectations for the region and for the countries where our ratings are focused (mainly in Argentina, Bolivia, Brazil, Chile, Colombia, Mexico, and Uruguay).

<sup>4</sup> See "Credit Implications of Healthcare Reform in 2009", January 2009 (114040).

<sup>5</sup> See "U.S Healthcare Insurers: Industry Pressures Prompt Negative Outlook", October 2008 (112126).

## Are Insurers and Investment Managers on the Road to Recovery?

Given their higher degree of investment leverage (investments relative to capitalization), Latin American life insurers and pension companies are likely to be relatively more affected than property/casualty insurers. Credit insurers and specialists in financial lines (guaranty, surety) will also continue to experience some strain as a result of stresses on the credit quality of their insureds and their collateral.

### Investment and Liquidity Positions Generally Remain Sound

Credit spreads on investments – after spiking to peak levels in the fourth quarter of 2008 -- have since been subsiding. Latin American insurers generally invest on a buy-and-hold basis, and in general have only limited demands on their liquidity. This advantage insulates them from the need to sell otherwise performing assets at temporarily distressed values.

Regulators in some jurisdictions have also given insurers latitude to avoid marking-to-market sovereign debt investments. Despite carrying non-investment-grade ratings in many countries, these are generally the most liquid instruments available to local financial institutions.

Most significantly, insurers in Latin America, as elsewhere, are not broadly dependent on short-term funding, or on ready access to debt and equity capital markets, as premiums and deposits are their primary source of operational funding. Furthermore, they generally employ little to no leverage in their capital structures, relying instead on retained earnings.

### Regional Macroeconomics: Mexican Insurers May Be More Vulnerable<sup>6</sup>

Mexico's proximity and economic ties to the U.S. economy, together with its heavy reliance on industrial sectors that continue to perform poorly in the current economic environment, suggest that Mexico will experience a sharper GDP drop than most other major countries' in the region. Notwithstanding the generally robust operating and financial trends evident in recent years, Mexican insurers may soon experience a heavier impact on their earnings and business volume relative to other insurers' throughout Latin America.

That said, the country's investment-grade profile, strict regulatory investment guidelines, and tightened financial discipline should remain key sources of strength underpinning the sector's overall stable credit profile.

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## European Insurance

We began 2009 with a negative view on the European insurance sector, driven by lower earnings and capital concerns. Although the recovery in capital markets has relieved some of the immediate credit pressures, we believe that it is simply too early to declare that the sector is on the road to recovery.

Although shareholder equity and solvency ratio levels have held up reasonably well year to date, Q1 2009 was generally challenging for earnings, especially as a result of equity market-related impairments. Earnings prospects for 2009, and potentially beyond, will likely be constrained.

<sup>6</sup> Moody's Outlook for the Mexican Insurance Market, July 2009

## Are Insurers and Investment Managers on the Road to Recovery?

### Balance Sheets Are Being De-risked, But Are Still Exposed to Volatile Markets

In the short term, Q209's general improvement in capital markets bodes well for earnings and solvency, and European insurers' liquidity profiles generally remain good. We continue to see asset de-risking activity among European insurers, as well as substantial provisioning in respect of corporate bond defaults.

European insurers (particularly life insurers), however, continue to remain exposed to falling equity markets (equities often represent up to 15% of their total invested assets), as well as to mounting bond defaults. In our view, such financial dangers have not markedly diminished since earlier this year, and they continue to obstruct the sector's path to recovery. Rising government bond yields could also lead to significant unrealized IFRS-basis losses, which would then depress shareholders' equity. However, this risk needs to be considered in tandem with the extent to which these securities are held to maturity and thus avoid realized loss.

### P&C Insurers More Pressured by Economy Than Sinking Equities

The non-life business is particularly exposed to deteriorating economic conditions, and consequently the sector's medium-term recovery remains stalled. Several factors are responsible: lower investment yields, higher reinsurance costs, and a recessionary environment likely to lead to an increase in fraud-related claims.

In recent months, premium rate increases have generally been below the level of claims inflation. For many countries in Europe, we note that the motor line of business -- still the most important line for most groups -- remains under pressure from harsh competition among the main players. We expect this line to remain unprofitable for the rest of 2009.

In the medium term, moreover, potential exists for higher inflation in light of the huge amount of government money in the global financial system, and such inflation could in turn lead to rising insurance claim costs. European insurers therefore need to be more proactive in obtaining price increases now, notwithstanding the recent reduction of expense ratios through cost efficiencies. We view the challenge of achieving and maintaining good levels of underlying profitability to be key to the sector's recovery.

More positively, non-life insurers continue to maintain relatively low exposures to equity markets.

### Life Insurers' Affected by Shaken Consumer Confidence and Volatile Capital Markets

For the life business, trading conditions are still very difficult: historically low interest rates are squeezing new business margins and are lifting the cost of policyholders' guarantees. Furthermore, competition in certain product lines remains harsh, and it is intensified by top line pressure from the global recession, especially with regard to products that are most vulnerable to discretionary spending. Further margin pressures could arise as certain players become more competitive on price as they look to maintain, or expand, market share.

Looking forward, an environment of rising interest rates would be economically beneficial to European life companies because this situation would broaden margins and cut the cost of guarantees. The same situation, however, can lead to swelling outflows and shrinking inflows as alternative savings avenues like short-term bank deposits become more attractive, particularly in many European markets where life business is not tax-sheltered.

On balance, we expect the European life sector to see a continued period of slow growth and thin profitability until consumer confidence returns and until capital markets show sustained stability or improvement.

### Reinsurance Demand and Higher Prices

January renewals showed only modest price increases in reinsurance, but these have nevertheless continued to harden as the year progresses. The demand for reinsurance appears to be increasing because the balance sheets of primary companies are constrained and because financial turmoil has cramped supply.

We think that the reinsurance market is experiencing a slow -- but seemingly sustained -- beneficial upturn in market conditions. The approaching hurricane season, however, may deplete Group's capitalization; in the absence of additional capital, this could slow the sector's recovery, or even lead to selected negative rating actions.

## Are Insurers and Investment Managers on the Road to Recovery?

### Access to Capital Improving

In recent months, the sector as a whole has seen a noticeable improvement in access to debt and hybrid markets. Of course, the volume of issuance is considerably lower than it had been before the crisis, and the cost of the debt is somewhat higher. Nevertheless, it is encouraging to see the markets willing to provide funding to insurers with a strong investment rationale.

Fixed charge coverage remains depressed for most of the re/insurance players, however. We expect that this ratio will be pressured, thus limiting potential medium-term recovery for some names. We base this opinion on the prospectively lower- than- historical earnings for most European players, coupled with higher interest amounts..

### Conclusion

Notwithstanding the welcome improvement in capital markets during Q2 2009, we believe it is too early to conclude that the sector is on the road to recovery. We continue to factor into our ratings the potential for equity markets to fall (by 25-30% from year-end levels) and for corporate bond defaults to rise significantly.

If equity markets drop no farther, and if there is no more major widening of bond spreads, and if investment grade defaults become no worse than our base scenario, and if rising interest rates can be managed via good duration management, the prospects for non-life insurers are encouraging.

For the troubled life players, both the continued economic slowdown and their greater exposures to asset markets are restricting credit improvements. More certainty on the economy and recessionary environment would be needed to prompt real optimism about their situation.

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## Asian Insurance

Asian insurers, including those in Australia, have seen their bottom lines and capital butters eroded by significant losses in their investment portfolios over the past year. Losses appeared to have peaked in the final quarter of 2008 and all stock markets in the region have recovered, some more than others.

Asia Stock Market Performance 3Q 2008 - 2Q 2009 (%)		3Q08	4Q08	1Q09	2Q09
Australia	S&P/ASX 200	-11.79	-19.09	-3.77	10.41
China	Shanghai SE Composite	-16.17	-20.62	30.34	24.7
HK	Hang Seng Index	-18.49	-20.14	-5.64	35.38
India	BSE Sensex 30 Index	-4.47	-24.98	0.63	49.29
Japan	Nikkei 225	-16.48	-21.32	-8.47	22.8
Korea	KOSPI Index	-13.54	-22.35	7.27	15.24
Taiwan	Taiwan Taiex Index	-23.98	-19.72	13.5	23.44
Singapore	Strait Times Index	-19.97	-25.32	-3.5	37.24

## Are Insurers and Investment Managers on the Road to Recovery?

But, stock markets will remain volatile in tandem with economic indicators. With all of the latter pointing to contraction, insurers are expecting flat or minimal revenue growth for the rest of 2009. However, with a number of larger economies, such as China and India, forecasting a less severe contraction than previous estimates, we see a recovery in the life and non-life sectors in 2010.

### Insurers Face Similar Pressures Across the Region

In this context, it is important to note that even though Asian insurance markets are extremely diverse in terms of maturity, size and regulatory oversight, the issues confronting them – in the wake of the economic downturn – are very similar.

Apart from the more immediate impact on stock values, a slowdown in the Asian economies will continue to pressure insurers' top-line performances. As such, premium growth will be negligible or even negative as business volumes and investments decline.

The impact of natural catastrophes has proven more costly than in the past for a variety of reasons, including the fact the take-up rates on insurance have increased and populations in urban areas – which are often affected -- have risen. These catastrophes will exact a toll on company bottom lines as a consequence of larger and more frequent payouts and also increase the cost of reinsurance.

### Life Insurance

Even though sales of investment-linked products are expected to remain in the doldrums, protection products are one segment that has seen growth in some markets. In times of economic stress, customers are much more sensitive to risks, and a renewed focus by life insurers has raised awareness and renewed interest in traditional protection products.

However, although the major economies in Asia anticipate growth in the sale of traditional products, it will not be enough to offset the declines in the sales of investment-linked products.

### Non-Life Insurance

The non-life sector with a smaller exposure to equities was less affected by the collapse of the stock market. Nevertheless, premium revenue, especially in commercial lines, is expected to mirror the economic contraction.

Claims arising from natural catastrophes have been increasing in size and frequency. Therefore, higher costs and more restrictive terms for reinsurance protection could limit what an insurer is now prepared to write, with a corresponding impact on its revenue.

However, with planned rate increases and improved penetration, insurers in this region will limit the impact on their top and bottom lines.

### Rating Implications

After our rating actions -- from negative outlooks to selective downgrades -- for a number of Asian insurers, we do not envisage any further significant negative rating actions. However, positive rating outlooks or upgrades in the near term are not likely as recovery to pre-crisis levels will be slow and moderate due to the following:

- regional stock markets remain volatile despite a recent rebound, which could prove short-lived;
- Asia's economies continue to slow with no immediate signs of a sustained turnaround;
- lower interest environment will remain for some time;
- insurers need more time to rebuild their capital bases.

Despite the expected decline in premium volumes and lower investment income yields, as indicated, there is no immediate downward ratings pressure. However, for companies whose capital has been significantly

## Are Insurers and Investment Managers on the Road to Recovery?

eroded by realized and unrealized losses, their ability to meet regulatory capital ratios may require them to take on more debt and increase financial leverage.

Increased operating costs not matched by a corresponding increase in premiums will affect profitability and restrict the ability of the insurers to generate organic capital. This in turn will constrain their financial flexibility.

Whilst the significant drop in profit on its own will not have immediate rating implications, its impact on capital and financial flexibility and any reversal in the recovery of the equity market could lead eventually to negative rating actions.

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## Financial Guarantors

### Uncertainty About Ultimate Losses Hinders Sector Recovery

The severe dislocation in credit markets over the past two years has left many financial guaranty insurers in precarious financial condition as a result of losses on mortgage-related exposures. It is premature to consider the industry in the recovery phase, despite unmet demand for the product because substantial uncertainty remains about guarantors' credit profiles.

Indeed, the current situation of the guarantors is more appropriately described as a loss-validation phase. This is a period when guarantors and their counterparties are tracking market data, whether macroeconomic trends or insured exposure performance, to assess the reliability of current estimates and to determine the potential effect of new information on projected losses.

The guarantors' large operating leverage and exposure to impaired credits (8-to-1 mortgage and ABS CDO risk to qualified statutory capital and loss reserves, in aggregate, with large variability across companies) mean that relatively modest changes in loss estimates can have substantial effects on capital adequacy.

### Unprecedented Stress

The bond insurers have faced unprecedented stress, primarily from their mortgage related exposures. The most adversely affected guarantors had large ABS CDO exposures in addition to direct RMBS risks. The weak direct RMBS performance (primarily second lien and increasingly Alt A losses) and the RMBS concentration and leverage in ABS CDOs contributed to large paid and projected losses at most guarantors. Out of the seven Moody's-rated guarantors active in 2007, only one, Assured Guaranty (and its newly acquired FSA subsidiary), actively writes business today. Berkshire Hathaway Assurance Corporation, a recent entrant, is the only other active guarantor. The other guarantors are essentially in a suspended state of operations.

### Approaching the Bottom?

The industry remains under substantial stress as losses on residential mortgages continue to increase. Other insured sectors, most notably CMBS (especially CMBS resecuritizations given the leverage on leverage), are showing signs of stress, and could, in some scenarios, become major loss contributors. Municipal credits, guarantors' largest exposures as a percentage of par insured, are also buckling under the weight of the economic crisis. The recent downgrade of California to Baa1, municipal scale, from A2 was a notable negative development; guarantors insure \$13 billion of California general obligation debt, and substantially more from municipal issuers within the state.

We have been updating its guarantor ratings, with Assured Guaranty and FSA still under review for possible downgrade, to reflect current views of their risk profile, including recently-revised RMBS loss estimates. We would expect the conclusion of these rating adjustments to coincide with a bottoming of the market, but that may not hold true. Substantial uncertainty remains about portfolio credit quality, and we anticipate substantial

## Are Insurers and Investment Managers on the Road to Recovery?

additional credit losses in some reasonable downside scenarios, leaving some guarantors particularly exposed. Any additional economic weaknesses -- especially in areas affecting mortgage performance, such as employment and house price appreciation/(depreciation) -- would ensure further deterioration.

### Rating Outlooks Reflect Instability in the Market

Despite some positive signs on the broader economy, credit conditions have not sufficiently improved to provide a clear path to recovery. Uncertainty about ultimate losses is such that many of our ratings have outlooks that are either developing or negative. The most common uncertainties relate to the actual performance of their insured portfolio, as exemplified by the wide spread between expected and stress losses on RMBS-related exposures or on the actual risk of CMBS resecuritizations.

We estimate stress losses on RMBS exposures as a multiple of expected losses, and find a wide range of possible credit profiles (in some cases, from strongly to weakly capitalized, or from weakly capitalized to undercapitalized), depending on where ultimate losses fall.

Other insured segments may also be exposed to possible deterioration, and we are monitoring their performance closely. Additionally, the outcome of some ongoing litigation could have substantial consequences for some firms' credit profile. Certain guarantors are, or could be, negotiating commutations or settlement of risks and claims with their counterparties, and the results of such transactions could significantly change their financial standings.

### Challenges to Business Model Mitigated by Lack of Alternatives

The magnitude of the stress faced by the industry has increased market skepticism about guarantors' business model and value-added. The remaining uncertainty about ultimate credit losses is also contributing to market discomfort. Some segments of the municipal market, large investors, and strong municipal issuers currently show limited interest in the product, and structured finance opportunities are rare, contributing to a substantial reduction in demand for the product.

At the same time, both the sharp decrease in the number of active financial guarantors and available insurance have left many smaller and riskier municipal issuers unable to issue debt, highlighting the current limited set of alternatives to financial guaranty insurance and demonstrating the remaining captive demand for the product. Such strong demand for the product from these participants, as well as attractive pricing (by historical standards) and limited current supply, has raised the interest of potential new entrants.

### Expected Improvement of Visibility Could Lead to Rating Actions

We expect guarantors to face a fairly dynamic environment over the next 12 months, with many of the current uncertainties discussed earlier either narrowing or vanishing, leading to additional rating actions in the sector. For example, actual credit losses falling within our expected range could free up capital resources at the strongest guarantors, thus improving their risk profiles. By contrast, losses in excess of our current expectations could exhaust the capital cushion at some firms or magnify stress at others. Many of the ongoing claim negotiations or litigations with counterparties are likely to be resolved in the coming year, with possible implications for the credit profiles of the affected guarantors.

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## Are Insurers and Investment Managers on the Road to Recovery?

### Mortgage Insurers

We expect the industry to report its 8th consecutive quarterly loss and to continue that trend well into next year. The business environment and credit profile for mortgage insurers have worsened from a year ago. Since then, the effect of the credit crisis has spread to the broader economy, as reflected in an increasing jobless rate and continued decline in house prices. Even prime mortgages, which represent a substantial portion of the total mortgage insurers' exposure, are now suffering from more defaults despite efforts on the part of the government to modify loans in order to make them more affordable.

With these negative trends as a backdrop, the beneficial impact of a broader economic recovery on the mortgage insurance industry is clearly not yet evident. In fact, the industry may be poised for further deterioration. Both the business model and franchise value of the mortgage insurance industry are highly reliant on the structure of the mortgage finance market, which could well be transformed in the wake of the proposed Financial Regulatory Reform, which includes the future role of Fannie Mae and Freddie Mac (collectively "the GSEs"). Furthermore, rising unemployment, when combined with continued declines in house prices, suggests that losses will likely keep rising.

Such issues have substantially constrained access to the public markets and have led mortgage insurers to press for the federal government to extend support that has not yet been -- and may never be -- provided. Capital preservation is a key focus for the industry, and mounting losses and capital constraints limit opportunities to write more profitable new business. Rating outlooks for many mortgage insurers are developing; depending on the outcome of these uncertainties, the ratings for mortgage insurers may be positively or negatively affected.

### Entire Structure of U.S. Mortgage Finance Market Could Change

The future role of the GSEs, along with doubt about the final regulatory framework, substantially clouds the prospects for the mortgage insurance industry. Historically, stable demand for its product was provided by the GSE charter requirement for credit enhancement on loans that are greater than 80% loan-to-value.

The administration recently announced that, as part of the proposed Financial Regulatory Reform, the strength and stability of the GSEs (at least for now) are critical goals. At the time of the President's 2011 budget, the fate of the GSEs will be determined; the initiative cited a range of outcomes, running from preservation of the status quo to the elimination of these enterprises.

On the other hand, the proposals also suggest that banks and other originators may be required to retain an economic interest in the credit risk of securitized transactions. Such an involvement could increase demand for mortgage insurance as a means to manage regulatory risk.

### Pressure on Consumers Remains High

Expectations of rising unemployment rates and declining house prices are likely to continue to push up losses for the mortgage insurers, particularly in the lower risk, larger segments of the insured portfolios. Delinquencies appear to be stabilizing in those areas that were more susceptible to poor underwriting, such as Alt A and subprime mortgages. Additionally, these parts of the portfolio are more likely to benefit from the rescission rights of the mortgage insurers to deny claims on mortgages that did not meet underwriting standards.

Nevertheless, the spill-over effect of economic deterioration on prime quality mortgages could be more detrimental here because this segment represents approximately 70% of the industry's overall exposure. Admittedly, the government is pursuing efforts to modify mortgages to make them more affordable and thereby to reduce the foreclosure rate, but it is still unknown whether these measures will be effective.

### Access to Capital Is Constrained

Rising losses and the uncertainty regarding future business prospects and the eventual return to profitability have both narrowed access to capital for publicly held mortgage insurers, such as MGIC, Radian, and PMI. To replenish it, these companies have sold assets, and thus have effectively exited most international markets.

## Are Insurers and Investment Managers on the Road to Recovery?

Genworth, Republic, and UGRIC, owned by more diversified holding companies able to provide capital and/or reinsurance solutions, have fared slightly better.

The federal government has yet to provide any form of capital relief for the industry. In an effort to preserve capital, mortgage insurers have substantially reduced new business volumes; such shrinkage has been done despite management's price increases and more conservative underwriting standards, and this situation, as it stands, will further delay a return to profitability. If the outcome of the GSE reform does not cramp future demand for mortgage insurance when losses begin to stabilize, existing mortgage insurers may find themselves competing for capital with novice entrants completely lacking legacy books.

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## Managed Investments: Asset Managers

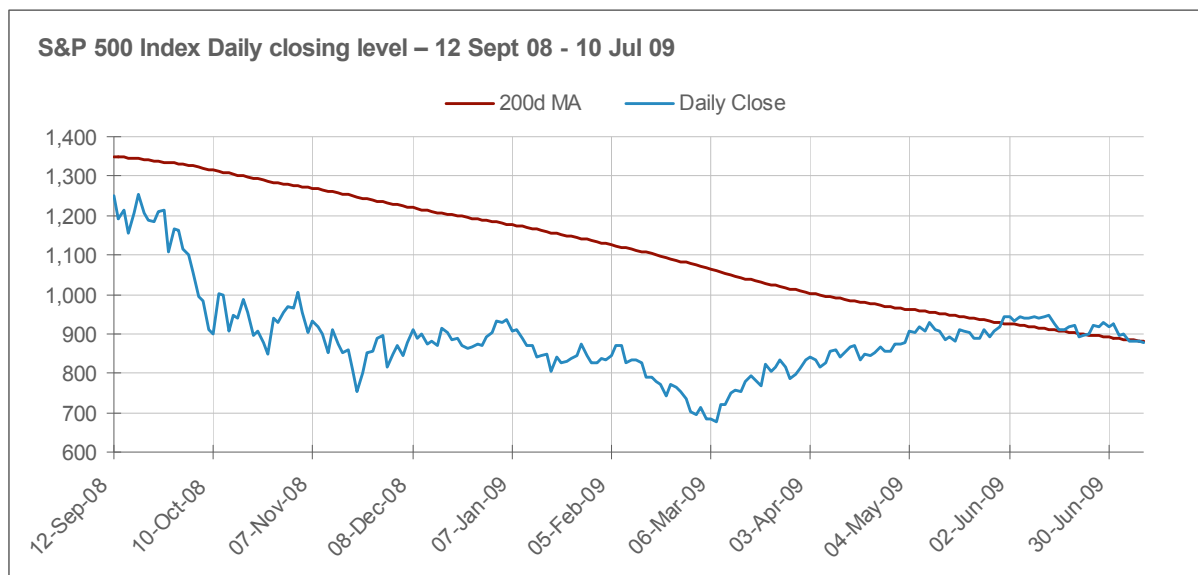
### **Equity Market Rebound and Flows Have Stabilized the Sector, but Weakness Reigns**

The credit picture for asset managers has improved and stabilized since 1Q09. Relative to the first half of 2008, however, the industry is substantially weaker because of reduced earnings (EBITDA) -- that are roughly half of what they had been. Clearly, any stabilization is precarious.

A favorable near-term outcome for the industry (if there is to be one) would simply be holding onto the recent market gains. What would it take to truly improve matters? Either equity markets need to rebound further, or asset inflows must be stronger. Given the drastic cost-cutting efforts of asset managers, the resulting impact on operating leverage means that it wouldn't take major up-ticks in assets under management (AUM) to kick-start revenues, but few market watchers see much potential for a sustained lift in the equity markets. (AUM is a key measure from which asset managers' revenues are determined.)

In spite of our prevailing message of weakness, the past quarter has indeed seen some stabilizing forces at work -- market-wise primarily, and in M&A. The three-month run-up of the equity markets between March 9 and June 12 managed to restore AUM back to late-4Q08 levels. The market run has since flattened, spotlighting investors' thin confidence in the likelihood of a robust recovery. (See chart).

## Are Insurers and Investment Managers on the Road to Recovery?



At least investors are returning to long-term investments, especially in fixed income assets. The industry has seen a complete abatement of 4Q08's dramatic net asset outflows. Investment Company Institute data shows that 2009 is firmly back on track for net positive inflows. The first six months this year showed net inflows of approximately \$145 billion in the United States, versus just \$70 billion in the first six months of 2008, and a negative sum of \$296 billion in the last troubled six months of 2008.

### The Biggest Need: Rising Equity Markets

Global markets are up dramatically since early March (by over 30% in many cases), but the *average* quarterly levels of key indices do not show such powerful moves. The changes in equity indices are highly indicative of changes in daily average AUM, and therefore, of quarterly revenues, as is highlighted in the boxed-in data in the table below. The table also shows modest improvements in the indices in 2Q09.

Nevertheless, equity index levels are still in a range running 30-40% below 2Q08's, and probably will remain that way for a while. With both earnings and cash flow-generating capacity at half of what they were at the beginning of 2008, less cash is available for debt service, bonus accruals, acquisitions, and share buybacks.

### Average Daily Closing Values of Major Equity Indices

Relationship between index changes and revenue changes <sup>1</sup>	2Q09	1Q09	4Q08	3Q08	2Q08	1Q08
FTSE 100	4,258	4,040	4,270	5,359	5,979	5,890
% change from prior quarter	5%	-5%	-20%	-10%	2%	
Nikki 225	9,279	7,940	8,760	12,788	13,789	13,315
% change from prior quarter	17%	-9%	-31%	-7%	4%	
Dow 30	8,320	7,774	8,842	11,323	12,507	12,401
% change from prior quarter	7%	-12%	-22%	-9%	1%	
S&P 500	851	809	916	1,252	1,371	1,353
% change from prior quarter	5%	-12%	-27%	-9%	1%	
Average change in equity index	9%	-10%	-25%	-9%	2%	
Changes in Revenue <sup>1</sup>	nr	-7%	-24%	-11%	3%	
Changes in EBITDA <sup>1,2</sup>	nr	-26%	-41%	-9%	0%	

nr = not yet reported.

1 - Weighted average changes in total revenues for 8 public, investment grade asset managers: BlackRock, AllianceBernstein, Invesco, Franklin Resources, Legg Mason, Waddell & Reed, Eaton Vance, and Janus.

2 - Changes determined using Moody's definition of EBITDA, which typically includes stock option expense.

## Are Insurers and Investment Managers on the Road to Recovery?

### Operating Leverage Will Drive Substantial Earnings Volatility – Favorable and Otherwise

Asset managers have generally completed right-sizing staff and other expenses to new, lower revenue levels. Because new revenue dollars can be added with limited variable expense increase, favorable operating leverage (i.e., a higher increase in operating earnings for a given increase in revenues) will be significant when markets rise. If markets fall, managers will reluctantly face further, and painful, cost-cutting because they have already sliced quite deeply.

### Capital Preservation Remains Critical -- but M&A Could Rally

Investment managers have been, and overall remain, defensive in the face of AUM declines since mid-2008, by focusing on expense saves and preserving capital. Increasingly, however, we believe that their stance may become more offensive in light of the BlackRock-BGI acquisition announcement and stabilizing markets. The BlackRock-BGI deal helps to support asset manager valuation multiples, and it might even improve the conditions for raising capital.

Thus far in 2009, capital-raising has released potential rating pressure on the firms executing such deals. Also favorable for several of them are recent credit facility (bank loan) amendments that are bolstering safety margins to covenant thresholds on total debt/EBITDA measures. These amendments, however, come at the cost of higher usage spreads and smaller maximum borrowing levels.

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## Managed Investments: Hedge Funds

The hedge fund industry has suffered in the last two years from the severe stresses caused by the market dislocation which started in 2007 and which further intensified in the latter part of 2008. These stresses caused widespread negative returns across the industry and subsequently led to a decline in the size of the sector, both in terms of number of funds and assets under management, thus reversing the trend of spectacular growth in previous years.

Although conditions remain challenging for many hedge funds, by and large, returns have moved into to positive territory in the first five months of 2009, as signs of more normal market conditions started to emerge. Indeed, many of the issues that we had seen erupting in late 2008 and early 2009 -- dysfunctional markets in various securities, illiquidity, de-leveraging, and significant investor redemptions -- all seem to have run their course, and sentiment has improved.

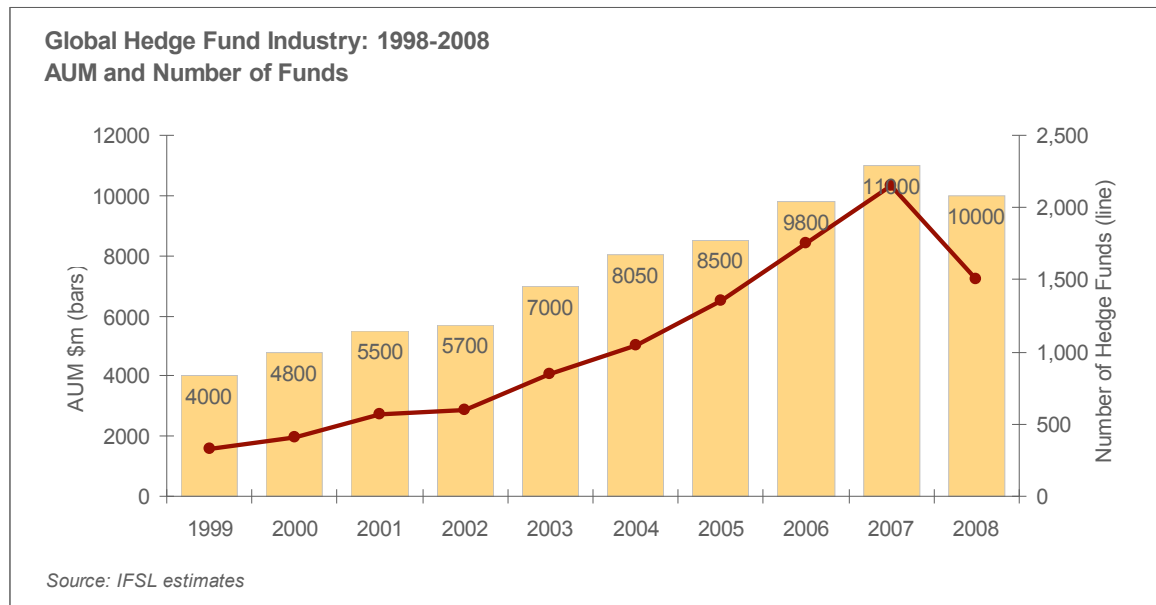
Yet, there are still changes and challenges that hedge funds are facing globally. These include industry consolidation, changes in investor composition and the desire for longer-term capital, investor focus on operational controls, and regulatory scrutiny. Although the market recovery may prove to be temporary, the foundation has been laid for material changes in the industry's dynamics. We believe that, in the long run, many of these changes will likely be positive from an investor's point of view -- barring of course any overly aggressive regulatory changes.

## Are Insurers and Investment Managers on the Road to Recovery?

### Size Matters

A key dynamic has been consolidation. Both the hedge fund industry's asset pool and the number of its players have shrunk from their peak<sup>7</sup> and better performing funds, typically the larger players, now make up an even larger proportion of the industry. As banks significantly reduced their funding facilities and carefully trimmed their client base, the larger, more established funds have found themselves awarded with "preferred client status," particularly in terms of access to funding and financing.

On the other hand, many of their smaller counterparts continue to struggle. This situation has left the larger funds armed with stronger financing capabilities and thus better positioning to seize opportunities. Smaller funds have also found it difficult to keep top talent and attract new capital at the same time. Further consolidation of the hedge fund industry seems therefore likely, resulting in a leaner industry.



### The Investor Base Is Changing

Given the inherently diverse, non-homogeneous and highly fragmented nature of the hedge fund industry, performance dispersion last year was understandably wide across funds and strategies. Somewhat surprisingly, even funds that outperformed in 2008 -- including those that had not suspended redemptions or imposed gates -- suffered from substantial outflows as their investors -- mainly funds of hedge funds and investors through the private banks -- sought liquidity. As such, in recent months, hedge fund managers have been focusing their capital-raising efforts on attracting a more institutional clientele, in a bid to build a more stable, longer-term focused capital base.

Moreover, many investors are also negotiating better terms, asking for lower management and performance fees, and fund managers are now more willing to accommodate their demands in a bid for more capital. In return, some of the latter are asking for a longer lock-up period to ensure a more permanent capital base. We expect this shift in investor composition to a more institutional client base to be also accompanied by an increased focus on due diligence and on operational risk management, particularly as hedge fund managers themselves become more institutionalised.

### Focus on Operational Controls

Prior to the economic downturn, we had seen that funds -- particularly the larger ones -- had started, or at least were well into, the process of strengthening their operational processes and controls. During the throes of the

<sup>7</sup> Although estimates of industry size vary greatly, all figures show that in recent months total assets under management have declined substantially. For example, according to Hedge Fund Research, the total hedge fund industry assets are \$1.3 trillion (down from an estimated \$2 trillion) and number of hedge funds have declined to 9,050 (from over 10,000).

## Are Insurers and Investment Managers on the Road to Recovery?

recent market turbulence, operational risk may have largely taken a backseat, but certain funds reaped the benefits of having built tight controls and were thus better equipped to deal with the global turmoil. Indeed, there may be a link between underperformance and operational quality because severe underperformance may itself be symptomatic of latent deficiencies in the hedge fund's operational infrastructure<sup>8</sup>.

Additionally, we note that many funds have been shrinking their balance sheets, simplifying their trading strategies, and heading back to basics -- thereby simplifying their overall operational processes.

Operational risk rushed back to the forefront in the aftermath of the Madoff scandal, which intensified the need for better investor due diligence and for greater transparency. As a result of this (along with the aforementioned reasons), managers will probably be expected to bolster their operational infrastructure.

### Regulatory Pressures

Given the global calls for increased regulatory supervision in the aftermath of the market turmoil, it is obvious that the industry will face regulatory changes. Various proposals have been announced already, some of which have caused uproar amongst industry participants.

Although regulation could add value, questions remain about what form it would take and whether it would hinder the funds' ability to execute their strategies or would make them unsustainable. Without a harmonised global regulatory regime, which is in line with the global nature of the industry, the risk of "cherry picking" jurisdictions by managers will remain, resulting in an industry concentration in select cities, nations, or islands.

Ultimately, regulation will take time to be implemented, but certain fund managers have already started to explore various alternatives, including moving to different jurisdictions, in the event that local regulations become too cumbersome.

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## Managed Investments: Money Market Funds

The credit picture for Constant Net Asset Value money funds (or "CNAV money funds") has stabilized considerably from the dark days of September 2008 after the Reserve Primary Fund failure. We currently view the stability in CNAV money market-fund credit quality to be well-grounded. However, recent improvements in the CNAV fund credit picture could be reversed by further deterioration in the credit ratings of large U.S. and European banks and/or a significant increase in net investor outflows.

We see very few near-term signs in the market that could trigger a fall-back to September 2008 lows. However, for improvements in the liquidity and credit picture of CNAV money market funds to become well-established, CNAV funds will have to show that they can operate smoothly in a world without governmental liquidity and insurance programs. Given this, we believe CNAV funds will slowly be weaned off government programs to effect a very smooth transition.

Last September, the CNAV fund industry found itself on the brink of collapse after the failure of the Reserve Primary fund sparked a "run on the bank" crisis in CNAV funds, which had been triggered in large part by the failure of Lehman Brothers. This period may always be remembered as a low point for the liquidity profile of

<sup>8</sup> See Moody's Special Report "Market Turmoil Increases Stress on Hedge Fund Operations", January 2009

## Are Insurers and Investment Managers on the Road to Recovery?

CNAV money market funds, but, all things considered, they have weathered the credit storm reasonably well, returning to some stability, thanks to government aid and safer investments.

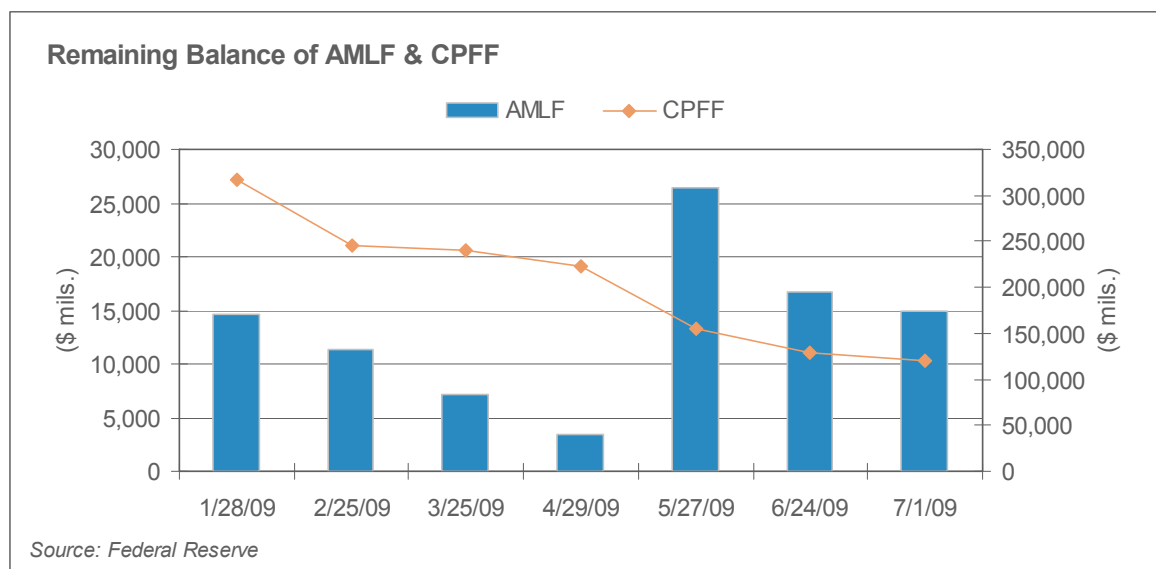
In terms of where CNAV money-fund credit quality is headed, we believe that the implementation of more conservative investment strategies, ahead of proposed regulation changes, should enhance funds' ability to meet their two primary objectives -- provision of liquidity and preservation of capital.

### Investment Strategies Have Been Adjusted

With the benefit of various support programs, CNAV money funds, which operate primarily in the United States and the United Kingdom, generally continue to pursue very conservative investment strategies, targeting higher-quality, larger allocations to short-dated securities issued by banks, particularly those that are systemically important, and corporations as well as governments.

In a low-interest-rate environment, however, some managers are extending the weighted average maturity of their portfolios to generate yields in excess of their management fees. This tactic exposes their funds to heightened liquidity and market risk, but it should not affect their overall credit risk substantially. These managers have typically handled such a situation by investing in longer-dated time deposits issued by systemically important banks or government securities.

The decline in usage of the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF) and the Commercial Paper Funding Facility (CPFF), which are two of the main U.S. governmental liquidity programs, is a positive sign of some improvement in money market conditions. However, the Federal Reserve's decision to extend these programs through February 1, 2010 signals that conditions remained stressed.



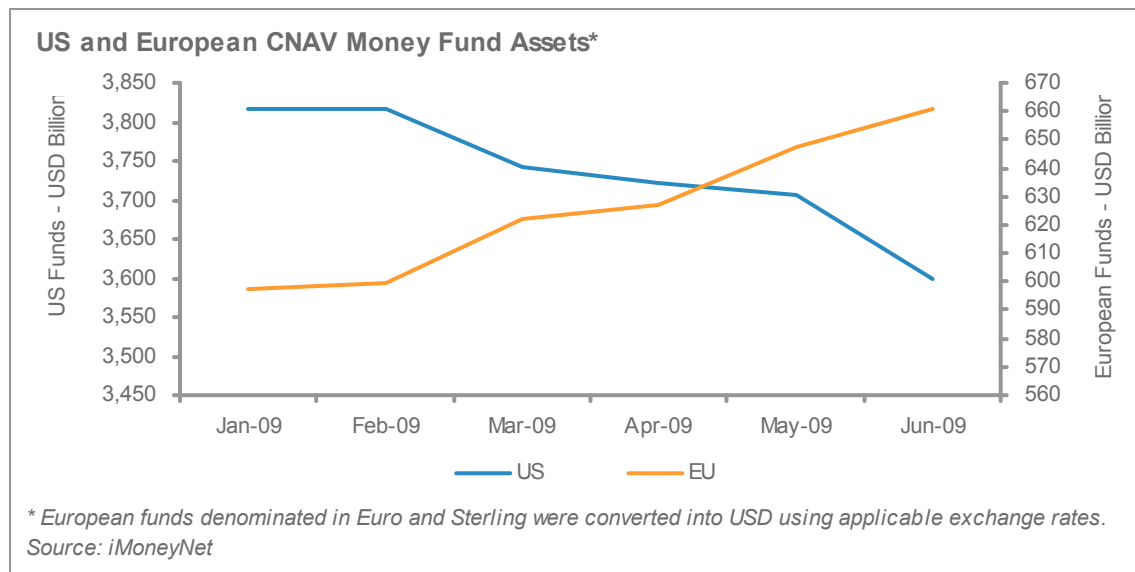
### Stability of AUM Bolsters Money Fund Credit Profiles

Assets under management in U.S. CNAV money market funds were down approximately 5% in the first six months of the year, while European CNAV AUM increased by 4.6%. Overall, the credit profile of CNAV money market funds has benefited from the stability in AUM because the decline in shareholder redemptions has reduced the need of fund managers to sell portfolio securities in the secondary market. It has also given fund managers more headroom to build liquidity within funds.

We would expect AUM in CNAV money market funds to become a little more volatile over the near-term. Most recent U.S. money market fund flow data show that CNAV money fund investor may now have less tolerance for current paltry yields. Absent an increase in money fund yields we would expect to continue to see run-off in CNAV fund MMF AUM.

## Are Insurers and Investment Managers on the Road to Recovery?

We do not envision that AUM run-off would be of a magnitude that would jeopardize recent improvements in CNAV money-fund credit quality. This view is based on our belief that CNAV funds have positioned their portfolios well over the past six months for elevated redemption scenarios. CNAV money market funds have also moved to a more conservative asset mix with significant allocations to bank risk (much of which enjoys Government support) and Agency securities. These efforts have bolstered the overnight to near-term liquidity position in funds to a degree that higher levels of investor outflows should have little impact on funds' credit profiles. Additionally, in the U.S., we also do not expect that the expiration of the U.S. Treasury's Temporary Guarantee Program for Money Market Mutual Funds (it is likely to expire on September 19<sup>th</sup>) will trigger a rush of redemptions in U.S. CNAV money funds.



### Regulators Reconsidering Money Funds' Operating Framework

Over the past nine months, U.S. regulators have considered a range of ways to tighten the regulations governing CNAV money funds to improve the funds' resiliency. At the end of June, the SEC announced its recommendations for changes in the regulatory framework governing U.S.-domiciled money market funds.

In our view, these recommendations should enhance the funds' ability to meet their two primary objectives; provision of liquidity and preservation of capital. Any regulatory changes affecting CNAV funds domiciled in the United States are likely to affect European CNAV funds as well; they are generally managed to a comparable standard, and European fund associations and regulators were closely following U.S. regulatory recommendations. Nonetheless, the proposals made so far do not directly address the issue of systemic risk posed by money market funds, and further changes may be forthcoming.

Meanwhile, in Europe, investment firms managing VNAV money funds have also begun to rethink their operating framework, while the relevant regulatory authorities have expressed the need for a review of regulation. EFAMA (European Fund and Asset Management Association) has published a revised definition for VNAV money funds, which appears more conservative than definitions currently used in European jurisdictions.

In addition, a number of European regulators -- including those of France and Switzerland, which regulate two of the largest VNAV money fund sectors in the EU -- are also advancing more prescriptive regulation, in addition to the work undertaken by EFAMA.

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Report Number: 119256

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