S&P Global
Market Intelligence

The Hartford Financial Services Group, Inc. NYSE:HIG

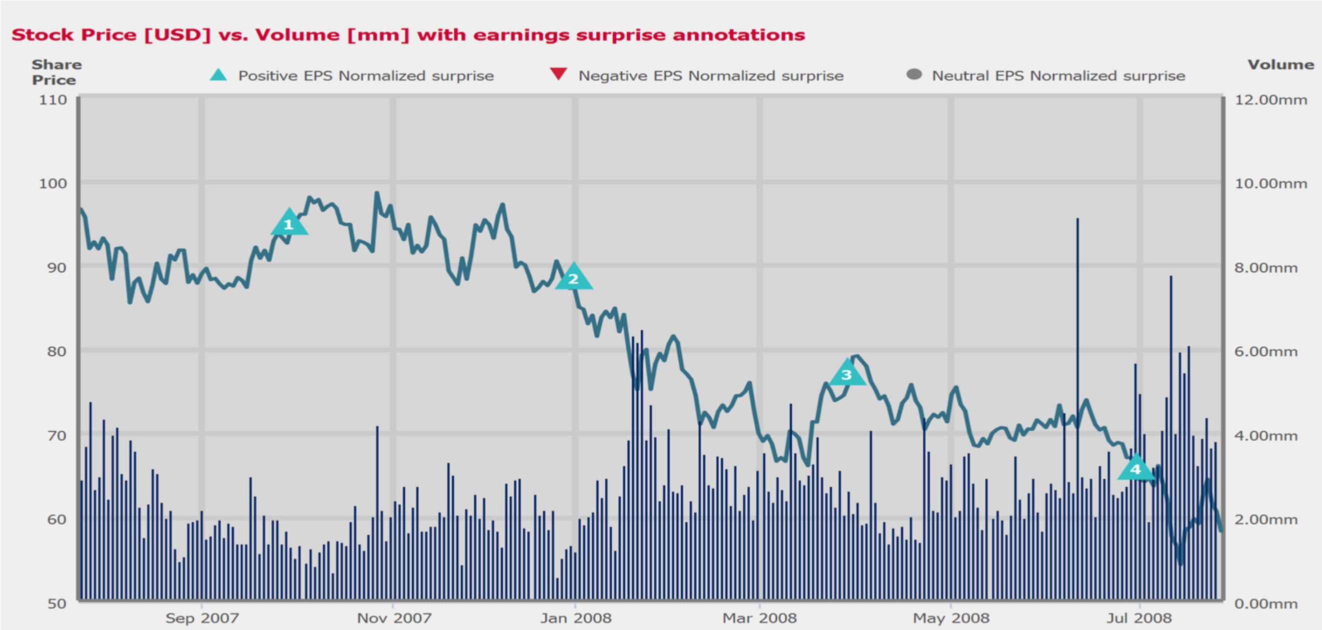
FQ3 2008 Earnings Call Transcripts

Wednesday, October 29, 2008 9:00 PM GMT

S&P Global Market Intelligence Estimates

	-FQ3 2008-			-FQ4 2008-	-FY 2008-	-FY 2009-
	CONSENSUS	ACTUAL	SURPRISE	CONSENSUS	CONSENSUS	CONSENSUS
EPS Normalized	(1.45)	(1.40)	NM	1.94	5.17	8.01
Revenue	-	-	-	-	-	-
Revenue (mm)	8883.73	(393.00)	NM	6670.47	22707.10	21604.36

Currency: USD
Consensus as of Oct-29-2008 7:54 PM GMT



- EPS NORMALIZED -	CONSENSUS	ACTUAL	SURPRISE
FQ3 2007	2.46	3.33	1 35.37 %
FQ4 2007	2.49	2.66	2 6.83 %
FQ1 2008	2.46	2.51	3 2.03 %
FQ2 2008	2.10	2.22	4 5.71 %

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EXECUTIVES

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Banc of America

Andrew Kligerman
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Bob Glasspiegel
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Dan Johnson
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Eric Berg
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Jeffery R. Schuman
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Terrie Shoe
Pioneer Investments

Tesha Jackson
Columbia Management

Tom Gallagher
Credit Suisse

Presentation

Operator

My name is Jeremy and I'll be your conference operator today. At this time I would like to welcome everyone to the Hartford third quarter conference call. All lines have been placed on mute to prevent any background noise. After the speakers' remarks there will be a question and answer session. (Operator Instructions)

I would now like to turn the call over to Kim Johnson, head of Investor Relations.

Kim Johnson

Thank you for joining us for today's third quarter 2008 financial results conference call. As you know our earnings press release was issued earlier today. To help you follow our discussion, a financial supplement and slide presentation are available on our website at www.thehartford.com.

Ramani Ayer, Chairman and CEO, Tom Marra, President and Chief Operating Officer, Greg McGreevey, our new Chief Investment Officer, and Liz Zlatkus, CFO, will provide prepared remarks. We'll conclude with our usual question and answer session. Also participating on today's call are Neal Wolin, President and COO of our property and casualty company, John Walters, President and COO of our life company, and Alan Kreczko, General Counsel.

Turning to the presentation on page 2, please note that we will make certain statements during the call that should be considered forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. These include statements about the Hartford's future results of operations. We caution investors that these forward-looking statements are not guarantees of future performance and actual results may differ materially. Investor should consider the important risks and uncertainties that may cause actual results to differ including those discussed in our press release issued today, our quarterly report on Form 10Q for the quarter ended September 30, 2008, our 2007 annual report on Form 10K, and other filings we make with the Securities and Exchange Commission. We assume no obligation to update this presentation which speaks as of today's date.

The discussion in this presentation of the Hartford's financial performance includes financial measures that are not derived from Generally Accepted Accounting Principles or GAAP. Information regarding these non-GAAP and other financial measures is provided in the investor financial supplement for the third quarter of 2008 and the press release we issued today and on the Investor Relations section of the Hartford's website at www.thehartford.com.

Now I'd ask you to move to slide 3 as I turn it over to the Hartford's Chairman and CEO, Ramani Ayer.

Ramani Ayer

Let's begin on slide 3. The third quarter was the most challenging in the Hartford's history. The markets we are experiencing are truly unmatched with dramatic spread widening in the credit markets and a substantial retrenchment in the equity markets. These elements factored heavily on our third quarter investment portfolio performance and earnings results.

Realized losses of $2.2 billion mostly from impairments and a $932 million DAC charge drove our net loss of $2.6 billion or $8.74 per diluted share. Core earnings in the third quarter were -$422 million or $1.40 per diluted share. In addition to the DAC unlock core earnings were hurt by catastrophes and negative returns on our alternative investments.

We're clearly very disappointed by our third quarter performance and we intend to focus this call on several key investor issues.

On the issue of investments we announced our new Chief Investment Officer, Greg McGreevey, earlier this month. Greg joins the Hartford from ING where he oversaw much of their investment operations for the

Americas. We're very pleased to have him on board and he will be a key figure on our investor calls. Greg will talk about our third quarter performance but I do want to make a few comments.

It is clear that overweight positions in financial services and structured securities hurt us in the third quarter. Over 70% of our third quarter impairments came from financials and we took real economic losses in some high profile names like Fannie Mae and Lehman. At the same time it is critical to note that $1.5 billion of our $3.1 billion of pre-tax impairments were primarily caused by price declines in financial services holdings, not defaults. We still expect to receive all payments of interest and principal from these highly rated quality issuers.

In our CMBS and subprime portfolios we have stress tested our holdings and impaired those securities where the cash flows weren't projected to hold up in a severe recession scenario.

On the issue of capital we closed the $2.5 billion Allianz investment earlier this month. The investment strengthened us at a time when capital is critical. Our resources continue to be tested by the global markets but even at today's market levels the Hartford remains well capitalized. Liz will provide additional color on this issue a bit later.

On the issue of liquidity investors have recently shown more interest in the liquidity profile of the insurance industry. Insurers with long-dated liabilities are more insulated from liquidity pressures as compared to other financial institutions like commercial banks. With over $10 billion in cash, short-term investments and other highly liquid holdings I feel good about the Hartford's liquidity position.

In terms of the Hartford's core business operations our property and casualty business is doing very well. Markets remain competitive but there are signs that commercial pricing declines are moderating. While it's too early to call a bottom, we're optimistic that we will see more attractive markets in 2009.

In our life operations our mutual funds, retirement plans and group benefits lines all showed healthy sales growth. Our investments in these lines have continued to pay off even in the face of difficult market conditions.

In our variable annuity business sales and earnings suffered from the global decline in equity markets. This extended period of market volatility will lead to changes in product and pricing in VA guarantees of the Hartford. There will continue to be strong consumer demand for living benefits and we certainly don't expect markets to remain as volatile as they are today. But we definitely believe a retooling of product features and pricing is warranted and we have begun that process.

With that let's go into more detail on these important issues. Tom will begin with an overview of our business results.

Thomas Michael Marra
Executive Chairman of the Board

Please turn to slide 4. Our property and casualty results for the quarter were strong especially when you take into account the heavy storm activity. We reported core earnings of $156 million.

Catastrophes had a significant impact on the quarter. The total impact from current year cats was $356 million pre-tax. This covers all cat-related costs including $325 million or 12.7 points in claims losses as well as reinstatement premiums and estimated state mandated assessments. On an ex-cat accident year basis our ongoing operations combined ratio was 91.8, a little more than a point higher than last year. This is an excellent result at this point in the underwriting cycle and reflects the discipline we are exercising.

In personal lines our ex-cat accident year combined ratio was 88.3, down slightly from the prior year. We are benefiting from mid-single-digit negative auto claims frequency and severity is virtually flat. In small commercial underwriting profitability was excellent with an ex-cat accident year combined ratio of 87.7 for the quarter. Low single-digit declines in expected claim frequency across most lines continued to contribute to our strong results.

Total net written premiums were $2.6 billion in the quarter, 1% below the 2007 level. Markets remain competitive and with the exception of personal lines pricing continues to fall. We are balancing underwriting profitability with growth.

In summary, our property and casualty operations had another very good quarter. Neal and his team have done a great job staying focused on day-to-day execution.

Now please turn to slide 5 for our life results. As you would expect our life businesses were heavily impacted by equity markets in the third quarter. The DAC unlock and negative returns on alternative investments reduce core earnings. With AUM down fee based revenues also declined.

Our US and Japan VA results were hurt by the slide in equities. Product competition in these markets remains intense and global markets are still struggling. We expect US and Japan VA sales and flows to be challenged until we see some stability return to these markets and we have reduced our fourth quarter guidance accordingly. Also as Ramani has said, we have begun a process to revise our product pricing strategies in the VA area in light of the market turbulence we are experiencing.

Our retail mutual funds, retirement plans and group benefits business showed a lot of sales resilience in these markets.

Mutual fund deposits were solid at $3.6 billion and net sales remain positive even as redemptions increased in September. Sales in October have continued to be good but like many others in the industry we are seeing higher redemptions. Based on what we are seeing so far, we are guiding to a range of $2.5 billion to $3.3 billion for mutual fund sales and $1.3 billion to $1.8 billion in net outflows for the fourth quarter. We believe we have a strong mutual fund franchise and are well positioned for growth in this business when markets stabilize.

Our retirement plans group had another quarter of great execution. Deposits were $2.3 billion, up 67% over the prior year, 13% on an organic basis.

Group benefits had outstanding results this quarter producing $100 million in core earnings for the first time. The record earnings were driven by favorable morbidity and good expense control combined with steady premium growth.

Finally, with revenues down across the company particularly in the life businesses we are taking a hard look at our expense base. We are taking actions in the fourth quarter and we are working on additional plans that will be implemented throughout 2009. At this point we expect to reduce our 2008 run rate by an estimated $250 million by the end of 2009. This will not come all at once but will be worked in over the course of the year and be fully in place by the time we enter 2010.

With that I'd like to turn the call over to Greg McGreevey to cover investments.

Gregory McGreevey

In the time I have today I'll cover the asset categories that had the largest impact on our third quarter results, our investment and financial services and structured securities. I'll also share some of my near-term and longer-term priorities.

Please turn to slide 6. As the slide indicates the crisis in financial services had a significant impact on the Hartford's third quarter results. Dramatic spread widening combined with declines in financial services preferred stock drove $2.3 billion of pre-tax impairments in the quarter. You can see a breakdown of the impacts of fixed income and equities on slide 6. Fully $785 million of the $2.2 billion in impairments were true credit defaults including institutions you already know like Fannie Mae, Freddie Mac and Lehman.

The remaining $1.5 billion were impairments primarily because we were not able to assert that they would substantially recover their value within two years. The two-year time horizon may be an area where we differ from others. A specific price recovery period is not prescribed in the accounting rules. In other words, $1.5 billion of the impairments we took this quarter were on high quality institutions where we had limited credit concerns. We feel this is a conservative view on the prospects for near-term recovery within financial services.

At the end of September we had $10 billion or about 11% of our portfolio in financial services. Virtually all of the third quarter mark-to-market changes in equities were recognized as realized losses this quarter. The net unrealized loss of about $800 million in financial services represents temporary price declines on high quality institutions. We have included a listing of our top 25 financial holdings in the Appendix of today's presentation.

On slide 7 we can take a closer look at our structured securities. The CMBS and RMBS markets have remained incredibly challenging. We were seeing the effects of both fundamental economic trends and a very high premium for illiquidity factored into pricing for these securities.

Each quarter we stress test the cash flows on our subprime and CMBS securities to determine if and when we expect them to recover. This quarter we worsened our loss assumptions for the severe recession scenarios for both subprime and CMBS. Average home prices for example are down 20% since their peak in the summer of 2006. Our stress test assumed home prices nationally will decline an additional 20% for an overall decline of 40% from peak to trough.

For CMBS we are now using assumptions for defaults and severities that are approaching the worst commercial real estate environment recorded in the US since 1980. As a result of our stress testing we impaired roughly $500 million pre-tax primarily in CRE CDOs and lower-rated recent vintage RMBS.

As you can see on the chart we have about $3.5 billion of net unrealized losses in CMBS and RMBS. We expect no loss of principal or interest on these assets using our severe recession scenario test and we have the ability and intent to hold these securities until they recover.

Looking ahead the pace of economic recovery is uncertain. Credit markets as we all know are still quite volatile and spreads have widened further in October. We are optimistic that the aggressive steps being taken by the Treasury and Fed will eventually help to strengthen financial institutions and in turn stabilize real estate valuations. We have taken significant impairments over the past four quarters in subprime and CMBS. In the Appendix you will find three slides that show our current investments at PAR, book and market value based on original rating. I think you'll find this additional data provides greater clarity on our pricing for these securities.

I'd like to close with a few comments on the Hartford's investment portfolio and next steps. From an asset mix perspective the Hartford has a broadly diversified fixed income portfolio. That said and as Ramani indicated, we have overweight securities that are exposed to the real estate market: CMBS, home equity and financials. I am planning to take a series of actions aimed at repositioning the portfolio in light of current economic outlooks.

First. I intend to enhance the overall credit quality of the general account. Today we're investing in treasuries and high quality securities and maintaining higher than average liquidity. This is not a long-term strategy. We are looking for markets to stabilize and when they do we will put risk back on the table. Our investment decisions will seek to balance risk, returns, capital and earnings.

I also intend to continue to decrease our exposure to credit derivatives, shrink the securities lending program and reduce exposure to certain capital intensive and volatile asset classes like hedge funds. I don't want to suggest that we can make wholesale changes in the portfolio near term. It's not economically prudent or feasible to sell severely depressed assets at the height of market fear. Over time however we will make prudent portfolio decisions that effectively optimize investment performance, capital and earning stability.

With that I'll turn it over to Liz.

Lizabeth H. Zlatkus

I would like to walk you through our updated 2008 guidance so please turn to slide 8. As you saw in our press release we have lowered our core earnings guidance range to $4.30 to $4.50 per share. The range assumes an average of 315 million shares outstanding which gives effect to the Allianz investment. The new range reflects actual performance for the first nine months of the year including the third quarter DAC unlock.

You will recall that we provided an estimate of the market impact relating to the DAC unlock of $330 million to $640 million on the second quarter call. That was based on separate account performance through June 30. As you know, markets subsequently fell sharply in the third quarter with the S&P 500 down 9%. We incorporated all of that market impact into the unlock.

Our guidance also includes a fourth quarter charge resulting from about $3 billion of VA assets in Japan that triggered an account value floor. This charge relates to the 3WIN products. This is a variable annuity with an accumulation benefit rider sold in Japan. The rider includes the floor benefit which is triggered if the account falls 20% below the amount of the original investment. Then the policyholder has two options. One, to withdraw 80% of their original investment with no surrender charge. Two, to recover the entire original investment through a 15-year payout annuity.

The severe global sell-off in equities and bonds in October caused virtually all of these policies to hit the 20% threshold. This will impact the fourth quarter by $185 million to $225 million. Most of this charge reflects a DAC write-off.

Our guidance also reflects the loss of about $90 million from limited partnerships and other alternative investments in the fourth quarter. Returns on these investments continued to be poor.

Finally, you will note in our press release that we provided guidance on fourth quarter ROAs and like asset management businesses. This is a slight change from the past but with three quarters and a significant DAC unlock behind us we thought guiding on the fourth quarter alone would be more useful.

I also want to comment on capital and liquidity. The Allianz investment announced in early October supplemented our capital resources with an additional $2.5 billion. Of course much has changed since the beginning of October. We have seen dramatic declines in the markets across the globe. The S&P has dropped nearly 20% this month and volatility levels have hit all-time highs.

Given the current markets projecting a year-end capital margin is extraordinarily difficult. Credit spreads, currency rates and interest rates are fluctuating day-to-day and the sensitivity of these various assumptions in our capital models is much more acute in the tail. In this environment we are not comfortable providing a forecast of our year-end capital margin. However what we can say is that as we sit here today, the Hartford is capitalized at levels that are consistent with the standards that rating agencies have historically used for AA- level companies.

The difficult market conditions have resulted in heightened concern among the rating agencies. While capital is a key factor for the rating agencies, they consider a number of other factors in their ratings determinations.

We have implemented a number of actions to enhance our capital position and are working on other alternatives that could reduce the amount of capital that we are required to hold. As Greg indicated, we are reducing our exposures to certain higher risk asset classes. We are also looking at ways to maximize the capital efficiency of our reinsurance programs including the potential for captive reinsurance.

Finally, the Canadian regulators recently made changes to their capital requirements given the extreme and rapid market declines we are experiencing. We also understand the ACLI is exploring the possibility that the regulatory capital requirements in the US could be similarly modified. We would support these efforts. Of course changing the rules will take time and there are no guarantees it will get done.

Over the past few quarters we have increased our holdings of cash, short-term investments and treasuries. We built those resources to $7.8 billion at September 30 not including assets we hold as collateral in connection with derivative transactions. With the $2.5 billion cash infusion in October that’s over $10 billion of liquidity. When you evaluate this against our potential cash requirements, I feel good about our liquidity position.

You will also note that we have supplemented our 10Q this quarter with additional disclosures regarding sources of short-term liquidity as well as potential uses.

Finally, I'd like to give you an update on the Hartford's GMWB hedging program. Our program continues to perform within our expectations. Of course the capital markets in the third quarter represented a real challenge for any dynamic hedging program as equity fell and volatility soared. These factors contributed to a GMWB loss of $133 million pre-tax in the third quarter. Most of the third quarter loss was incurred in September when markets really fell.

In October market conditions have continued to deteriorate and we clearly have seen higher losses to this point than we did in September. Some of that would be expected to unwind should market volatility subside so at this point we can't forecast a full quarter impact.

Three issues are driving most of the losses in the quarter and month-to-date. First, we have been under-hedged for [VEGA] or volatility for some time. We felt [ball] prices were unreasonable and decided not to chase it upwards. The second driver is basis risk where the performance of our VA mutual funds differs from the indices. This has been a negative for us. Finally, transaction cost increase when markets become more volatile.

It is important to note that our hedging program is just one aspect of our overall equity risk management. We dynamically hedge only about 44% of our US GMWB account values. Market risks relating to the remaining 56% of the block have been transferred to third parties through reinsurance and customated long-dated derivatives. We are pleased with this prudent approach which has allowed us to lock in equity risk protection when costs were much lower.

With that I'll turn the call over to Ramani.

Ramani Ayer

We'll begin the Q&A session in a moment. Given the volatility of the market environment, it is really impossible for me to predict when some normalization will occur. In the meantime there are several areas as you've heard that we're focusing on.

First, we're going to stay focused on executing in a disciplined way in our insurance businesses. Second, we're going to review our VA business and rethink our product and pricing strategies in light of what we have seen over the last few months. Finally, we have begun the process of repositioning our investment portfolio under Greg's leadership with an emphasis on higher credit quality and greater capital and earnings predictability.
With that operator you may now open the call to questions. I'd ask each caller to limit himself or herself to two questions to allow us to get to as many callers as possible.

Question and Answer

Operator

(Operator Instructions) Our first question comes from Nigel Dally - Morgan Stanley.

Nigel Dally
Morgan Stanley

Liz, with capital should I be reading from your comments that it's unlikely that you will be needing additional capital based on where you stand today? And also if you could perhaps comment on whether you'd be interested in participating in the Treasury TARP if that opportunity were provided to you?

Lizabeth H. Zlatkus

As we stand here today with market levels, we feel very well capitalized. But in terms of would we access the CPP program if it's available, we certainly think they're favorable terms as we see it and we would look to do that.

Operator

Our next question comes from Josh Shanker - Citigroup Global Markets, Inc.

Josh Shanker
Citigroup Global Markets, Inc.

I'll give you an easy question and a hard question. The easy question is, the market indicators in the US are down about 20% since the beginning of the last quarter. I'm wondering in terms of the DAC charge we saw for the third quarter, would you be waiting till the third quarter of next year before the market results beginning October 1, 2008 would be incorporated into your analysis?

The second question, thinking about all the money that you've spent on your hedging for the past few years that we've talked about at great, great length, do you feel that you've gotten anything in terms of protection on your income and protection on your capital from putting that money to work?

Lizabeth H. Zlatkus

Let me first take the DAC question. We would plan to do a study as we always do in the third quarter so we would plan to do that next third quarter. As you know, if markets would deteriorate, we'd have to look at an unlocked off quarter. At this point we're about halfway to that point and the markets are down significantly so we're not looking to that but you guys can certainly look at the Q and run the numbers in terms of looking at market levels and thinking about the impact.

In terms of the hedging program, I think it's worked as we expected it to work. These are the most extreme conditions I think we've ever seen and the level that the asset has risen has been quite dramatic just in the month of October alone the asset on the non-reinsured part of it has risen over $2.2 billion so that goes directly to benefit our statutory surplus position. On a mark-to-market basis when you're marking the liabilities to market and the asset under GAAP, you're seeing some of the slippage but from a statutory perspective the whole asset value of the hedge goes directly to benefit DAC.

Ramani Ayer

Let me add one point to Liz's point. I think she expressed this on DAC. There's some information in the Q but basically markets would have to deteriorate substantially from here for us to have an off cycle unlock. So we're not anywhere near that yet. There's still a lot of room from that standpoint.

Operator

Our next question comes from Dan Johnson - Citadel Investment Group.

Dan Johnson
Citadel Investment Group

I remember in a slide presentation some time ago you walked us through stat reserving requirements for the life company under I want to say it was 10% and 30% decline markets or 15% and 30% decline markets. Maybe that was a year ago or so. If we did that again today and used the assumption again of 15% from here or 30% from here, what sort of statutory capital requirements would be created?

Lizabeth H. Zlatkus

One thing I would tell you is those slides were back at market levels that were much higher than they are today. One of the difficulties in being able to give ranges when you're in the tail already is that as you get farther into the tail a lot of other factors start to really have a bigger impact, like currency levels, interest rates, global market indices. So to be able to say what happens if the S&P drops 100 basis points or 15%, what's the impact on your capital margin, a couple things.

Number one, that capital market was trying to be a number above the rating agency requirements and in these kinds of market levels those numbers are swinging. What I would say is as we look here today we feel very adequately capitalized at a level for a AA- company. We have had impacts to our statutory capital for sure because of the VA requirements where it's expected to not only take the market level you're at but it expects you to then shock it down another 30% to 40%. So you can see why this is a very extreme measure.

As a reminder, that capital call is not cash so as markets recover that money would come back in terms of reserve releases or capital releases. But to be able to give a number from this point when you're really in the tail is just not practical.

Operator

Our next question comes from Andrew Kligerman - UBS Warburg LLC.

Andrew Kligerman
UBS Warburg LLC

Before I ask my question, I just want to stay with Dan's question. Maybe you could just help us extrapolate a little bit. The market was down 9% in the third quarter and we had extreme volatility. What was the impact on your capital position as a result of that, just your VA business? How much was it hit in the quarter?

Lizabeth H. Zlatkus

Obviously we had an impact on statutory offset by our hedged assets but the numbers are only year-end numbers so we're always forecasting; we don't C3 phase 2 calculations at the end of the quarter. It's always a projection of year end so that test is a year-end test. So we have to forecast again what swap spreads, interest rates, volatility levels, etc. would be at the end of the year. What I would say is with markets deteriorated as much as they have since the end of the quarter, it definitely has impacted our capital. We feel well capitalized today. We feel we can take further market declines but being able to give a specific number is not possible. Again it's a year-end projection number.

Operator

Our next question comes from Ed Spehar - Merrill Lynch.

Ed Spehar
Merrill Lynch

I want to stay on this too because Liz I guess I don't understand how you can say you feel comfortable with your capital position and yet you say you can't give us any idea what the number is. I think at this point it's impossible to say those two things in my view. So I really want to keep on this and hopefully we can get some more hard numbers on this because I find it very hard to believe that the Hartford doesn't have an idea about what the statutory capital impact is from an equity market decline. If you don't, it's very hard for us to be comfortable about what the risk profile is of the VA business. I understand all the factors and I'd appreciate it if you could just give us a little bit more than just what are all the different inputs that affect the number and try to get us to some number.

Lizabeth H. Zlatkus

That's a fair question. Obviously these are complicated formulas. So here's what I'll say. When I talk about how we feel good today, it's because I'm trying to stop the clock today. If I wanted to look at a 30% decline from 9/30 market levels which was 1,165 on the S&P, we think that our NAIC risk based capital number would be in the 300 range. Why am I saying that that's a number that we can kind of look at versus rating agency margins? It's because the rating agency formulas, there are four of them, and as I said in the extreme tail all of the formulas are very different and all of these different currencies, etc. impact that. Those things also impact RBC but I feel we can say something like that. 300% RBC with a 30% decline.

Thomas Michael Marra
Executive Chairman of the Board

Just to clarify, it's a year-end calculation so assume the S&P ends 30% down from quarter end and that's the result you would get, the 300% RBC.

Lizabeth H. Zlatkus

The reason when we talk about capital in the quarter, the impact on actual statutory capital for the quarter via hedging was not that significant. What I think you're really asking is: What is the capital impact related to the hedging on for example rating agencies or the amount of capital you would want to hold? That's where it gets a little bit more difficult. But again a 30% drop from 9/30 we think would be in the 300% RBC range.

Operator

Our next question comes from Bob Glasspiegel - Langen McAlenney.

Bob Glasspiegel
Langen McAlenney

A couple questions on hedging. How much collateral do you have with Lehman currently regarding in the money positions?

Ramani Ayer

I believe we have written off all our Lehman stuff so we don't have any residual and the last bit of collateral that we had with Lehman we had transferred that to another counterparty. So we do not have any existing Lehman collateral is my best understanding. Is that correct, Greg?

Gregory McGreevey

That is correct.

Operator

Our next question comes from Tom Gallagher - Credit Suisse.

Tom Gallagher
Credit Suisse

Liz, just to beat a dead horse and go back to the variable annuity related pressure on capital and overall just the capital margin as you said. When you pre-announced results and announced the capital raise, at that point you had a $3.5 billion capital margin. If we stopped the clock today based on where equity market levels are, I can appreciate that you don't want to give an update to that because things are fluid but how much of that margin gets eaten away by the variable annuity statutory capital requirements, whether it's [C3Phase2] or [carvum]? That's question number one.

And then a question for Greg. In terms of your impairment methodology, I just want to understand if you will continue to stick with the two-year recoverability test even as illiquid and as depressed as the fixed income markets are or whether you're potentially going to ease that rule? I would assume if you stick with that then more of the CMBS portfolio potentially gets impaired but maybe you could just comment on that.

Ramani Ayer

Greg, you want to take the first one?

Gregory McGreevey

Yes. That's a very good question. I think that's something that we're looking at very closely with the SEC literature and guidance that's coming out. There's no question that we've seen unprecedented spread widening and obviously we were seeing default levels that go well beyond historical levels or any recession that we've seen in the last 30 or 40 years.

At the end of September however the decision we made was based on at the time the accounting literature that was out there and our view of the two-year recovery. As I said in my opening comments, we probably deviate a little bit from others who may be looking at the same issue but we took that view albeit somewhat conservative in light of some of the stuff that's come out since then. So I think that's something we'll look at this quarter in light of a multitude of factors.

Lizabeth H. Zlatkus

In terms of we wanted to look at a 900 market level and I would say all in VA related changes. If you stopped right there, it wouldn't be that material. It's as you start to go down into the lower market levels. I would say the problem I'm having is the rating agency models are changing so if I try to look at more of a risk based capital number, you'd be in the $2 billion+ range over that. What's difficult is trying to assess what the rating agencies are really looking at right now. There are a lot of changes that are going on and that's one of the reasons it's more difficult to be able to project a year-end number and even project what the rating agencies are going to do.

Operator

Our next question comes from Eric Berg - Barclays Capital.

Eric Berg
Barclays Capital

I suspect like others I'm still confused in the following sense. It looks like notwithstanding the favorable activity in the market yesterday that the S&P is down very significantly in the month of October, whether it's 20% or 22%. How could it be that we've had a 20% decline in equities and if I understood your last answer correctly, this is not having a material impact on your regulatory capital given the increased reserving requirements for variable annuities with guarantees? How's that possible?

Lizabeth H. Zlatkus

It's clearly having an impact. As you go down into these market levels, the impact from VA in terms of both the reserving requirements as well as the additional capital you have to hold under [C3Phase2] does rise dramatically. There is an offset of course with our hedged assets and our reinsurance program so that certainly helps protect the books because vol levels have screeched up dramatically. Our hedged asset has also gone up by several billions of dollars. So I'm not at all suggesting that these markets aren't having an impact on our capital.

What I'm trying to get at is we certainly still have at the 900 market level, we have additional capital measuring how much above a certain rating agency is difficult so as I said if we looked at a 30% decline from 9/30 levels and if I just look at an RBC ratio because that's something that's a little bit more factual than trying to determine different rating agency models, we'd be at a 300% RBC range.

Ramani Ayer

And the 30% off of 9/30 puts you -

Lizabeth H. Zlatkus

At about an 815 S&P level. But again I'm giving you a little bit of a range there because it depends a bit on what interest rates are and what currencies are, etc. But I think that 300% range is something I feel comfortable with. Again, definitely impacting us. We have some offsets with our hedged assets, with our reinsurance program and obviously we got $2.5 billion from Allianz so all those things allow us to be able to make that statement.

Operator

Our next question comes from Darin Arita - Deutsche Bank Securities, Inc.

Darin Arita
Deutsche Bank Securities, Inc.

Two questions. One is going to stick with this capital margin question again if I may. Could you just walk through how we get from a $1.5 billion capital margin at the second quarter of '08 to the $3.5 billion estimate at year end per the pre-announcement? The second question is, with respect to the GMWBs, the hedge breakage there of $133 million. Does that include any FAS 157 items in there?

Lizabeth H. Zlatkus

Let me take your second question first. I think what you're getting at is how much did the recent change in the FAS 157 valuation techniques impact the quarter hedge slippage? I would say it was really immaterial. Most of the change in the liability was due to market movements and that would be the first question.

In terms of the second question, trying to figure out back in time where we were at any point in time. Things impact our statutory capital. We've had impairments, we have to mark-to-market impacts in terms of some of our asset classes that go through statutory earnings, so trying to go from the $1.5 billion to $3.5 billion essentially we got $2.5 billion in from Allianz. So that clearly gave us some uplift as well as we've made some decisions, some of these reinsurance efficiency programs that we're doing already has helped us or will help us by the end of the year.

Operator

Our next question comes from John Nadel - Sterne, Agee & Leach.

John Nadel
Sterne, Agee & Leach

Sorry. I'm going to do it too. Maybe thinking about getting at the statutory and the variable annuity issue and the capital cushion in a slightly different way. I was thinking about it this way. You guys announced the Allianz capital infusion on October 6 and the S&P was at about 1,000.

Ramani Ayer

1,150.

Lizabeth H. Zlatkus

All of our statements of capital margin at that time were referring to the 9/30 market level which was 1,165 S&P.

John Nadel
Sterne, Agee & Leach

Okay. Maybe we can think about it slightly differently. At least one of the rating agencies, Moody's I believe, saw something as you met with them or as you provided them with some information. They saw something, something important enough for them to put the life company on a negative outlook. It seems to me at least from afar important enough for you guys to think about going and talking to Allianz about a capital infusion.

I don't know. Maybe you can help us sort of to Ed's point understand some of the sensitivity here around what potentially they saw. I suspect it had to do with the VA capital hits with respect to [carvum] and [C3Phase2] and some of the sensitivity analysis that you've likely provided them with but maybe you can help us understand it a little bit more clearly as well so we have a better sense of what we need to be looking at that's more market sensitive as opposed to any other sort of data point.

Ramani Ayer

Let me take a first shot at it. Then I'll turn it over to Liz. One is the conversation with Allianz was not precipitated by Moody's so I want to be very clear on that because that's an inference. I didn't want to leave investors. The second thing is as far as Moody's are concerned, they're looking at not just annuity reserving issues, they're just looking at GAAP volatility in our earnings and other factors like that that caused them to consider what they did. I would encourage you to talk to Moody's because I'm very uncomfortable representing Moody's view on this call. So that's the second point I wanted to make.

Going to this specific question, what we said at the quarter close where we pre-announced as we said at 1,165 at that point in time, we felt given our conventional approach to looking at rating agency margins we said we had $3.5 billion cushion. Part of the reason you find Liz hedging right now is because rating agencies are in say flux in terms of defining how they look at capital and capital margins, we felt it would be more difficult for us to project year end based on rating agency capital requirements. That is the reason why we're trying not to do that.

Then she also said, which I just want to recap, looking at a quarter at 1,165 at 30% from there S&P as you're playing around in the tail becomes a lot more tricky now principally because there are other variables like exchange rates, like interest rates, etc. that affect the liability modeling and that is the reason why we're not trying to give you all a specific number to anchor your conclusions on.

We are trying to give you a sense from 1,165 if you were to have S&P decline 30%, we model that and at that modeling we think our RBC is modeled around 300%. There's obviously variability depending on all the other variables. That is the reason why we're trying not to forecast a rating agency margin. It's an important distinction. We're not trying to dodge your question but that is the reason why we're doing what we're doing.

I don't know Liz if you wanted to add anything to that.

Lizabeth H. Zlatkus

I think you said it well.

Operator

Our next question comes from [Tesha Jackson - Columbia Management].

Tesha Jackson
Columbia Management

I was thinking maybe we could skin this cat a different way. If we looked at the net present value at this point of what you're guarantees are, do you have a sense for where that is, like what the net present value is? Unless that's the number you gave us. If it was in a present value form.

Ramani Ayer

While Liz is trying to think about that answer, one thing I wanted to really assert here is these capital calls are not capital like you would see in the property and casualty business if you were to have a hurricane. The capital is gone from the system. These are capital calls based on shocking the reserve models by another 30% to 40% or so from year-end close and that capital comes back. So the economic costs of these annuities in the tail; first of all the payout is not until the very end till all the asset values get depleted so it's way out in the tail and therefore the present value of the economic costs is much, much lower. I just wanted to be sure.

Gregory McGreevey

It's pretty important that the actual claims are not made for years from now, 12 or 14 years from now in most cases so I know that you all know this but that is one of the factors and the capital can spring back as markets spring back as well. We've modeled that enough to know those spring-backs can be pretty pronounced. Liz, did you want to add anything?

Lizabeth H. Zlatkus

Yes. I would just say if you want to think about a present value, you can really look at the liability under FAS 157. That is, in fact some people would say it's an onerous calculation, but it's looking at risk mutual scenarios. It's really discounting the future stream of payments out under the current market conditions which are extremely onerous right now. At the end of the third quarter that liability number was about $2.4 billion. That's what happens every quarter. You mark your liability to market value which is essentially a present value number again under risk mutual scenarios and then you mark your asset which is your hedged assets to market and it's the difference between the liability valuation and the asset valuation that gets into those gains and losses. What ultimately will actually get paid out in terms of real claims is -

Tesha Jackson
Columbia Management

Anybody's guess.

Lizabeth H. Zlatkus

Yes. And certainly we believe that this is a pretty onerous condition to assume that if you took a point in time at 9/30 or even today that that liability valuation is the ultimate claims cost. We don't see it that way at all. So we think as markets rebound that liability's going to come down and as importantly separately as the statutory calculation is calculated and Ramani alluded to that, that is in a present value calculation.

It is looking at the worst 10% under extreme market conditions because you're taking a current market level and you're shocking it down another 30% and you're also shocking policyholder behavior down, you're assuming people lapse less and they optimize their benefits. So it's a very extreme test and you have to put the capital up. But once again as markets recover that capital gets released. So it is not a cash call in any sense of the word.

Tesha Jackson
Columbia Management

I think what everyone on the call is struggling with though is it may not be a cash call per se but I guess two points. After the Allianz announcement, it sounded like you'd have $3.5 billion-ish of excess capital assuming 1,165 market levels.

Lizabeth H. Zlatkus

Correct.

Tesha Jackson
Columbia Management

Clearly things are really different and now it's sounding like you think you're going to end the year with somewhere, and again I understand that there are a lot of moving parts so this isn't hard and fast, but a 300% RBC.

Lizabeth H. Zlatkus

If we ended the year at 1,165 -

Tesha Jackson

Columbia Management

No, no, no. If it was 30% down from 1,165 or the 815 then it would be a 300% RBC, which actually sounds to me like you're actually in a capital constraint position in that scenario.

Lizabeth H. Zlatkus

What I remind you is, we did say the 300% RBC range. That does not include any potential benefits for example of captive reinsurance programs which we're looking at. It also of course does not include that we accessed our contingent capital facility and there's also another variety of options that we're looking at to reduce the capital that would be required. We're just saying as we sit here today, [inaudible] benefit of any of those in because we have to make sure they all work and that it would be a 300% range. We still think that's a very well capitalized company [inaudible].

Tesha Jackson
Columbia Management

But if you look at your stock right now, basically the market is saying you need to raise capital or that's what the fear is is that you need to raise more capital and that it's going to be extremely dilutive to existing shareholders. So I think what we're all struggling with is how comfortable can we be that you're not going to come back to the trough basically?

Ramani Ayer

This is a tough question. We have no idea how to answer that question other than to say we will do what we believe at all times to be right from a shareholder perspective. I think what Liz is saying is even at 815 or so our RBC is around 300%. To tell you the truth, that's shocking it quite a bit. I mean 1,165 to 815 is shocking quite a bit. I think to have RBC of 300% feels to me like the system is able to withstand a fair amount of market retrenchment. But I honestly can't categorically sit here and say we will or we won't. You would not want me to say something like that.

Tesha Jackson
Columbia Management

I know. I mean I just think that's what we're all struggling with here.

Lizabeth H. Zlatkus

It's also like I said in Canada they've already relaxed the rules. There are a lot of things underway although we can't count on them right now but there are a lot of things underway that could put some capital relief on these numbers because again I think that when you're down at the tail with market declines unprecedented and then you're shocking it down 30%, there is a possibility that we could see some relief, which is another thing that we have in our quiver. Again I can't bank on it at this point.

Operator

Our next question comes from Alain Karaoglan - Banc of America.

Alain Karaoglan
Banc of America

Ramani, you mentioned that you might be retooling some of the products on the VA business. I assume that's with an idea of either decreasing the risk or increasing the return on capital given how year is capital. Maybe could you comment on what would the intent be and why wouldn't' you do the same thing on the property/casualty side if the cost of capital is a lot higher today, much more difficult to get, shouldn't you look at getting higher ROEs or being more cautious on that?

And the other question relates and I want to make sure from a shares outstanding point of view Liz. For 2009 what would be the shares on a fully diluted basis because the capital injection came in the fourth quarter as opposed to full year?

Thomas Michael Marra
Executive Chairman of the Board

I'm going to start the first part of the question and then ask Neal and John to quickly chime in and then we'll go over to Liz on the other.

First of all, on property and casualty, we're pretty darn happy with our ROEs even through the tough cycle. I'm really pleased with the way that business has performed and the way Neal and his team has managed it.

On the VA we just think it's the right thing to do at this point. We don't think this is the norm but we think volatility is going to be up for a while and we have to look at retooling the product which will mean price and product features.

Neal and John, why don't you quickly add to that.

Neal S. Wolin

I would just add that as Tom said, on the P&C side we're still very focused on writing business with a pricing discipline that delivers strong ROEs still in the 18% range for the quarter and not taking our eye off that ball. There's no question that that's something we will continue to be focused on. Obviously we want to get that right balance but we feel like we're delivering very strong business with a lot of pricing discipline in just the sort of way that would deliver that ROE strength.

John C. Walters

I would just add on the annuity product side, I think for some time now we've been at the lower end of the risk factor and relative to product. We're very comfortable with that position. We think it has served us well particularly in this difficult environment.

But we are going to go through a process of rethinking everything relative to the VA product which of course includes price and are we charging the right price for these products. It's difficult to know what the exact right price is because the markets are so volatile and I don't think you can price to the worst experience the markets have seen. But we've got to come up with what we think is a sustainable price over time and put that out there, and we've also got to look at the product features and which ones are really important to the client and which ones are the risk drivers and see what changes we want to make to that.

But we're pleased that we haven't really jumped into the competition and tried to match everybody over the last couple of years. I think that served us well and we'll continue to take that risk discipline into our rethinking as we go into '09.

Lizabeth H. Zlatkus

In terms of modeling for diluted earnings per share, if we look, I'm trying to estimated earnings per share for the fourth quarter, that would be about 329 million shares. When you try to go into the next year, you kind of have to estimate what the stock price would be because it impacts the dilution under the treasury stock method. So I would say it would be something north of 328 million but I can't give you an exact number. I would use that for modeling purposes and I think that gets you essentially there.

Operator

Our next question comes from Andrew Kligerman - UBS Warburg LLC.

Andrew Kligerman
UBS Warburg LLC

With respect to my question, what I really want to understand and you're talking about capital adequacy, you still have three rating agencies despite the capital raise that have kept your financial strength ratings on the insurance subsidiaries of the life division at either negative outlook or negative watch. The first question is with regard to doing this offering at all, why didn't you offer it to the public? I want to understand why you didn't offer this to the public. I feel like there's something that's not being provided here. What am I missing?

Ramani Ayer

We were looking into a market that was extremely volatile. We had not closed the third quarter and we'd have had to have closed the third quarter. If you look at us now, we are talking about October 29. That's when we would have had to have done this, meaning waited till then before we confirmed all our numbers, gotten audited numbers, etc. As I talked to our lawyers and others in terms of whether we can do this without audited numbers going public, their discomfort in doing all of that was extremely high.

So I sought to use an approach that I felt was swift because I believe the perception that we didn't have enough capital was every bit as important to tackle immediately as well as a substance of what might happen with respect to capital opportunities out here in terms of the markets receptivity to provide capital. So that is the reason why we did that. I made a judgment call on that given what I just told you. That judgment call is what resulted in the approach we took.

Really going out without fully audited statements, etc. in an environment like this becomes very, very challenging when we are sharing the kinds of numbers we are with you, and that is one reason why I decided to do it the way we did it.

Andrew Kligerman
UBS Warburg LLC

I want to retrace some steps. On June 10 Hartford announced a $500 million accelerated share repurchase. Current with that timing Ramani there were a lot of financial institutions that had discontinued their buybacks, they were having extreme difficulty. Some were going under. In the second quarter and early into the third you bought a total of about $1 billion of stock. So I want to understand what was being thought about back on June 10? What was missed at that time that you later realized?

Ramani Ayer

Very simple. I honestly missed, and this is a very clear answer, the degree to which markets have cratered in terms of equity markets, credit spreads widening, all of which happened in an accelerated way in September/October. I did not see that. We debated that internally. Liz and I talked extensively about whether we should buy back shares at that time, and I felt when we did the share repurchase we were doing it in an environment where investors were constantly worried about the fact that we would be sitting on excess capital and not responding to investor concerns when our stock was somewhat under pressure.

So that was to respond to that so you can't say at that point in time, "How come you guys didn't see what was about to happen?" And honestly, we didn't see that. We didn't see the degree to which markets got to where they are today.

Andrew Kligerman
UBS Warburg LLC

And you feel good going forward that with a new chief risk officer you'll have a better handle going forward?

Ramani Ayer

I want to be very clear. Forecasting in these kinds of markets even if I have the smartest risk officer is a great challenge but I'm very proud of the risk officer we have in place who certainly is looking at all aspects of risks including the risk we're taking on the investment side of the house so we're comfortable that we're going to do this very rigorously. But, Andrew if I were to go back and say would a risk officer have seen what happened in September/October, I think I still believe and I may be wrong, I'm willing to be called as not being clear on this but I do believe sitting there and for us to have said we would be in markets that go down as far as 900 and credit spreads widening so much, candidly I don't know if we could have called that then.

Because, if we could have we should have made a whole bunch of different decisions, not just capital raising. We should have done a whole bunch of different decisions so we did not see that magnitude of change.

Operator

Our next question comes from [Terrie Shoe] - Pioneer Investments.

Terrie Shoe
Pioneer Investments

I'm not going to ask the capital question but maybe it's all related. Earlier I think Liz you talked about and driving your fair value modeling policyholder behavior and you said that you had applied very stringent or conditions, not stringent but that you had shocked it with much higher withdrawal assumptions and such. Can you share some of that with us to the extent you can? And, what recent experience has been?

I would think given the present volatility in the markets and what the markets have done that there might be a significant change in policyholder behavior. What is currently built in to your pricing? And, when you say that you test it, how far do you take that?

Lizabeth H. Zlatkus

Let me try and take that in steps. You want to separate GAAP with stat and actual experience versus what we have to shock. So actually, through these markets we've seen that the policyholder experience has been very consistent with what we would expect and what we price in our products. So, I wouldn't say that there was any material difference there. Again, when you think of policyholder behavior, it's everything from asset allocation to lapses to when someone can reset in our principal first product, etc. So, I would say again experience is very consistent with what we price.

Terrie Shoe
Pioneer Investments

Are you concerned that there could be a delayed kind of behavioral change because this all happened so suddenly?

Lizabeth H. Zlatkus

Well, it's interesting because when you say what could happen. Why don't I finish and then I will answer that question because under FAS 157 we not only have to use prudent estimates of policyholder behavior, and again under risk neutral scenarios which is very low interest rate levels, when you're in the tail you have to shock that policyholder behavior down. You have to take your normal estimates and you have to assume that policyholders due optimize their benefit which would mean they would not lapse for example. They would move their money in to more equities.

That's kind of in the valuation. Your question is are we worried that people will in fact do that, the number one thing is it is sort of already in the FAS 157 to some degree. Then the second thing is for example if they started to lapse their policies, that would actually help from a liability standpoint because the guarantee would now be erased. Obviously that hurts now because if markets recover we have less policies and we have less future profitability so sometimes it's hard to decide what the impact is on the guarantee for that particular policyholder behavior versus what it is for the long term in force book of the business.

For statutory purposes, once again you have to take prudent best estimates and once again shock those in the tail. So, you're shocking policyholder behavior down to some point you're assuming extraordinary low lapse level which we've never experienced before. So far with markets declined this far, we have not experienced that. We feel very conservative in our assumptions and so very good that they would encompass policyholder behavior that's much worse than what we have seen.

Terrie Shoe
Pioneer Investments

How about usage though of the withdrawal benefit? Is that not an important variable?

Lizabeth H. Zlatkus

In terms of us seeing whether or not they're withdrawing when they take their 5% or 6%? Again, it is fairly consistent with what we price for.

Terrie Shoe
Pioneer Investments

Is it very sensitive to that assumption if the usage rate goes up a lot?

Lizabeth H. Zlatkus

That would be definitely something if 100% of the policyholders for example decided to start withdrawing that tomorrow, that definitely would have an impact. But, we're already assuming a fairly high withdrawal rate and again, it's policyholder behavior is consistent. I'm going to ask John to add some color to that.

John C. Walters

Terrie, just to be clear we have a dynamic modeling process that assumes that the deeper in the money a particular clients' policy is, the more they exercise all the benefits, one of the benefits being to stay with the policy because they're in the money, another benefit to take more income to exercise the guaranteed income that they have. We still believe that those policy assumptions that we've built in, the dynamic assumptions that we've built in to the models are still on the conservative end of what we would expect.

We've seen nothing in policyholder behavior to date that would cause us to feel any differently than that and it's well within our expectations at this point. It is clearly something we're going to monitor. We monitor it every day and so it's going to be something that we continue to monitor as we go forward and if we see a change in that then you would see a change in how we do our FAS 157 valuation.

Terrie Shoe
Pioneer Investments

Is it similar, the sensitivity both withdrawal, utilizing the withdrawal benefit as well as the lapse rate or are they very different? Is one much more important than the other?

John C. Walters

I can't say that one is much more important than the other. They are both important elements of the model.

Thomas Michael Marra
Executive Chairman of the Board

Just to maybe add some color to this because I really don't think there's a material risk that policyholder behavior is going to change dramatically. We've been selling this product since '02 and we've seen just about every season that you could imagine since then and behavior has stayed within reasonable boundaries so I really don't think this is a huge probability.

Terrie Shoe
Pioneer Investments

One other quick question, on your reinsurance program you're existing reinsurance program you have - and you show your reinsurance recoverable for the US, GM, WB, can you elaborate a bit more on your reinsurance programs? Is there any risk that that can't be continued? You said that you were looking at captive reinsurance alternatives, maybe elaborate a bit more on that.

Thomas Michael Marra
Executive Chairman of the Board

It's a lifetime guarantee for the policies that are already reinsured.

Terrie Shoe
Pioneer Investments

Right, so there's no risk whatsoever?

Thomas Michael Marra
Executive Chairman of the Board

It's a lifetime reinsurance program.

Lizabeth H. Zlatkus

Again, we obviously work with high quality reinsurers so we feel good about that protection, we feel very good about that protection.

Operator

Our next question comes from Mark Finkelstein - Fox-Pitt Kelton Crochran Caronia Waller (USA), LLC.

Mark Finkelstein
Fox-Pitt Kelton Crochran Caronia Waller (USA), LLC

Just a very, very quick question, as the Moodys negative outlook and I guess just general concerns over capital had any impact on your distribution partners or your kind of ability to participate meaningfully on the shelves that you're currently on?

Greg

Mark I'll start and then Neal and others may join in. First of all, it has not affected our distribution access at all so we're still selling in all the places we've historically been selling. We're very pleased with the continued opportunity that we have at our various distribution partners.

We do, as you would imagine get questions in this environment just like I think every company get's questions in this environment and we're fielding those and it has not had a meaningful impact on our sales results.

Neal S. Wolin

Mark, on the P&C side not at all. Our partnerships are strong and if anything our flows are up in October, really across our segments so no affect.

Operator

Our next question comes from Jeffery R. Schuman - Keefre, Bruyette & Woods, Inc.

Jeffery R. Schuman
Keefre, Bruyette & Woods, Inc.

I'm going to try and squeeze a couple of things in her but hopefully a couple of them are pretty quick. First of all, you've talked a few times about the scenario of the S&P going to 815 and the RBC at 300, I was wondering behind that what does that assume in terms of actually distributing the Allianz capital? Did all of it go to the life company or how much of it would be supporting that 300?

The second question is there some I guess sort of simple straight forward reason why you did not have a big FAS 157 non-performance risk factor impact when other companies did? Then the third thing, on the three win can you review just quickly for us again what the two customer options are and which one is most likely to be cake and whether there are additional customers still sort of pending out there that could potentially breach some level and create an additional problem?

Lizabeth H. Zlatkus

The first question, I'm going to turn the last one over to John but the first question from Allianz, when we're looking at that level, and again we're also including additional impairments, we're not expecting that right now but where the markets keep deteriorating we have to make some assumption about credit spreads continuing to widen so there's other impacts on our capital other than just variable annuities. But, we would be looking at utilizing a majority of that Allianz infusion.

From the non-performance risk on the FAS 157 adjustment, you may recall when we put in this adjustment in the first quarter of '08 that we had a very small adjustment for this of about $4 million. We did not use our own credit default swaps for that determination rather we looked at what we would consider the probability of default that we would default on our obligation to our policyholders. Obviously, that's very low because we honor our policyholders.

So, we looked at kind of a rating agency model, how they would view the probability of default on actually paying out to those policyholders and since that probability was very low it resulted in really an immaterial impact. So, when you kind of move forward in to today's market or even looking at further deterioration in the markets that number would not change.

Jeffery R. Schuman
Keefre, Bruyette & Woods, Inc.

John, the third question John has to do with the three wins, the election of options. Do you have a sense of how that's progressed?

John C. Walters

On three wins, in effect how this product worked was it had an 80% stop on it and so if the policy was down 80% you got shifted out of the variable annuity subaccounts and in to a fixed account and then you had an option of either taking your money out at 80% or getting your principal back over 15 years in an annuity payout. At this point about 95% of the policies have been stopped out because the market has declined so dramatically and about two thirds are taking the annuity payout option and one third is taking the cash out option.

Operator

Our next question comes from Daniel Johnson - Citadel Investment Group.

Daniel Johnson
Citadel Investment Group

The 300 RBC, is that like a corporation wide RBC or are we just talking particularly on the life company? And, where would that number have been I guess maybe at the end of 2007?

Lizabeth H. Zlatkus

At the end of 2007 that number was well in excess of 400%. We are talking about the life company. I'd just like to make another comment on this impact on capital and kind of the velocity of things that have changed. I think this relates to several of everyone's questions and just as a reminder, in the third quarter alone we took $1.7 billion impact in to our statutory capital for impairments.

I know we spent a lot of time talking about VA but I think it was the combination of the speed at which credit spreads widened and the impact on our statutory capital from that coupled with the impact of VA has obviously impacted our capital. But, as we sat back in that kind of June timeframe when Ramani is talking about, we had very healthy excess margins at that time but we've absorbed a significant equity market decline coupled with significant charges to our capital due to credit spreads widening and impairments.

Operator

Our next question comes from [Josh Smith - GRAACRF].

Josh Smith
GRAACRF

The 300 RBC, most people have targeted 350 as sort of the AA range, what's the numerator and the denominator on that 300? And, would you be willing to take a ratings downgrade if it was at 300 versus 350? And, are there any implications of a downgrade in terms of triggers that would set off any kind of redemptions or anything of that nature?

Ramani Ayer

Let me first talk to the second half of the question, would there be an impact of a ratings downgrade? There's some businesses that will get impacted, the institutional business would. But, I would say for instance on the property casualty side there are more property casualty companies that are A rating rather than a AA rating. There are very few at a AA rating so my sense is from a pure competitiveness perspective -

Josh Smith
GRAACRF

No, I was speaking specifically to the life company.

Ramani Ayer

On the life company side, the institutional business certainly Josh that would be an impact.

John C. Walters

But it would be more of a sales impact than it would be any sort of policyholder optionality impact. I just want to be clear on that point.

Ramani Ayer

Last thing, the numerator and denominator Josh, now you're talking about variables that are both volatile in the numerator and the denominator and I hesitate to give you that kind of answer because I think we're starting to get to numbers that are all estimates and at some point we start to worry that we're creating more noise.

Josh Smith
GRAACRF

To Jeff's question is any of Allianz contribution, is all of that gone to the life company or would some of that be available to sure up if the stress starts to the 300 RBC happened?

Lizabeth H. Zlatkus

I would say I'm trying to be conservative here so I'm looking at all of it but again, if we didn't have further deterioration in credits, if I didn't assume some additional impairments, etc. then I wouldn't have to use it all so there's a lot of moving pieces as Ramani said. We calculated it different ways, what if this happened, that happened.

Josh Smith
GRAACRF

No, I'm just confused on this point, if that 300, does that assume that all the Allianz contribution is already down there or is that before you could put some down there?

Lizabeth H. Zlatkus

Well certainly it doesn't assume all of the Allianz, we have to hold money as a holding company for dividends and other requirements but it assumes that we utilize most really all excess capacity and move it down to the life company. What I was trying to get at is if for some reason the S&P was down, but credit spreads narrowed and we didn't have further impairments then it would be better than that so there's lots of moving pieces. But, yes I am assuming that the Allianz funds are utilized.

Josh Smith

GRAACRF

Then just finally, why isn't 350 the target? Is it because there's support from the parent company? Other life companies have talked about a 350 target?

Ramani Ayer

I think Josh again this goes to Tesha's question, at some point we will - we have not made any decisions on that. I want to be very clear but, at the same time I think we will constantly remind ourselves that we have a balancing act. We've got three things to consider, how our competitive position stacks up, how we look at it from a shareholder perspective and third, rating agency margins are all a function of each individual rating agency so we'll take all three in to account. I've not made a decision on that issue but we're not automatically assuming that it will be met with a capital raise to 350. I just want to be very clear on that.

Operator

Our next question comes from Ed Spehar - Merrill Lynch.

Ed Spehar
Merrill Lynch

I just wanted to make sure, I feel like I'm still confused. Liz, I thought you said that if you had that shock scenario or the down 30 from 930 that maybe you'd have a $2 billion capital margin. Did you say that or did I not hear that? Then, I have a follow up so hopefully you don't go to the next question yet.

Lizabeth H. Zlatkus

No, that was a question that someone talked about the market levels today not shock down 30% from the end of the year. The S&P is above 900 right now, the numbers that I'm talking about with the risk based capital is in the 300% range was looking at an S&P of 815 and also assuming a variety of other factors including like I said some further deterioration in the credit market.

Ed Spehar
Merrill Lynch

I guess the thing that seems to be sort of hard to understand here is that you guys have always talked about modeling tail events and early on you gave us very detailed analysis of different outcomes for the VA book. I guess, you put that all together and you decided initially that it was appropriate to have a $1 billion or $1.5 billion capital margin or whatever we had. Then, you raise money and you say that you're at $3.5 billion, the market goes down 20%, the $3.5 goes to $2 billion. You're saying if the market goes down another 10% it sounds to me like you're saying you don't have anything.

I mean I know we're down a lot but 10% from here is like a week in the S&P the way things have been going potentially. I guess I just don't understand the level of capital volatility here. How could we not have seen this? I'm not asking you to forecast this occurring in 2008. I'm saying how could we not have seen this in our modeling when we are modeling tail event scenarios? We know all of these things about shocking the capital when we have the tail so I'm just curious why we didn't see this.

Ramani Ayer

A couple of thoughts, one is you're talking about how could we not have seen it say going back to year-end '07, is that what you mean?

Ed Spehar
Merrill Lynch

No, I just mean see it as a possibility not see it as a forecast but see it as a possibility. I mean we have had markets go down 30%, 40%, 50%, right. We had from peak to trough on the NASDAQ, we went down 75% earlier this decade so it's not like these things don't happen.

Ramani Ayer

Right, not across a balanced portfolio Ed. This is one of the most severe markets in terms of what has happened year-to-date and modeling at 800. Most of our models do look at a variety of things including what happens in the tail but we also have seen that one of the things that we did not see to the degree that it has happened is remarkable shifts in credit spreads. The third thing that we did not recognize or have not seen is the degree to which our concentration in the real estate sector through multiple sources meaning CNBS, RMBS as well as the financials is the other piece.

So, there were several other variables that interacted with this to create the kind of statutory capital strain. So, I feel like an intersection of variables that obviously were not encompassed to the degree that we're facing today.

Ed Spehar
Merrill Lynch

But Ramani I guess just what we're talking about here in terms of the market at 900 and something saying we've got a $2 billion margin to saying the market down at 815, 300% RBC with all the Allianz money accounted for suggests no margin and in fact it suggests at least that there's no margin. So, I'm just focusing on the equity piece. We did see this kind of move back earlier in the decade in terms of peak to trough for the S&P or worse I think. So again, I understand this is an unprecedented environment but that's what tail events are suppose to be.

Ramani Ayer

I agree but as far as '01 to '02 year-end I don't think we saw it but you're absolutely right peak to trough we did see the S&P go to July of 2002 where it declined dramatically. But, going back the degree of impairments we have taken and the degree to which spread have widened are two very important additional factors that effected all this change so those are two other variables that have caused some of this.

What we're saying is at 800 including the anticipation that if markets go down further there's a likelihood that there might be more impairments, I'm not saying that there will be more impairments, I'm not saying that there will be more impairments but we have factored all of that in the analysis and we're making a point estimate on that. That is really what we're trying to do.

Lizabeth H. Zlatkus

Ed, let me clarify, I think I'm not sure that $2 billion might have been trying to estimate a rating agency today. Again, I don't want to forecast what rating agencies are going to do going forward or what it's going to be at year-end. But, I think what you're saying is how could it drop off so much at 800 or 815 and I gave a range so at the 300% range at 800 you'd probably be in the 400 plus range at 900 so it definitely get's more convex when you go farther in the tail.

Again, I want to just remind you that's because you're sitting there at an 800 or 815 S&P level and you have to shock it down 30% more. You're talking about an extraordinary decline from 1468 at the end of 12/31/07 so there is a lot of convexity in that tail. I don't exactly remember, the $2 billion I thought was relating to rating agency which I was trying to avoid so let's just stick with RBC numbers 300% range and that 800 to 815 and 400% in that 900 range.

Ramani Ayer

So if you shock at 800 and you have to shock another 30% that's another 240 points off that is sort of like the way that [inaudible] reserving calculations work.

Lizabeth H. Zlatkus

Again, we are looking at a variety of opportunities like I said with that captive reinsurance. I think Terrie you had asked about that, I don't know if we answered you. That's just looking and certainly we would be working with the rating agencies to see how they would look through that but there are some potential efficient ways to reduce your capital requirements with captive reinsurance. So, that would be a plus to those numbers if that would work.

Ramani Ayer

Operator we're approaching 6:30 so we should take one last question. I don't mean to drag this call out because it is pretty late in the day. So if you could queue up our last question for us operator.

Operator

Your final question comes from John Nadel - Sterne, Agee & Leach.

John Nadel
Sterne, Agee & Leach

Just to tie down a couple of quick numbers, the 300% RBC ration, that estimate was based on the market going down to the 815 level, that's sort of the 30% down from the 1165. Do I have that right?

Lizabeth H. Zlatkus

Yes.

John Nadel
Sterne, Agee & Leach

What's the starting point? If we're at 1165 what would the risk based capital ratio be there?

Ramani Ayer

It will be north of 360 or so.

Lizabeth H. Zlatkus

No, it will be north of 400. What happens is we don't move money from the holding company down to the life company. So you're looking at an RBC ratio that's related to the life company so some of it depends on how much money you have to move down. Clearly, at high levels we can keep a lot more at the holding company and not have to push it down and still be well above -

John Nadel
Sterne, Agee & Leach

The rating agency targets?

Lizabeth H. Zlatkus

Exactly.

John Nadel
Sterne, Agee & Leach

The $1.7 billion of statutory impairments in the third quarter that you mentioned earlier Liz was that all in the life company or was that a combination of both the life and P&C?

Lizabeth H. Zlatkus

It was both the combination of life and P&C.

John Nadel
Sterne, Agee & Leach

Do you have the split?

Lizabeth H. Zlatkus

I don't have it.

John Nadel
Sterne, Agee & Leach

Then the last question was just to go back to the commentary sort of early on about sort of taking a closer look at the variable annuity business, thinking about retooling, perhaps even repricing, maybe it's a little too speculative and if so you can just say so but should we expect that there'd be any sort of consideration around repricing with respect to the in force? Or, is that sort of a prospective for new business consideration?

Thomas Michael Marra
Executive Chairman of the Board

We have the option to do some in force increases which are fully under consideration as well. Some of them are tied to how your new business for the same product line charges but John, we're going to definitely look at that as well.

John C. Walters

Just getting back to your question on the stat impairments relative to life and PC, it's about two thirds one third so about $1.1 billion or so was in life and the remainder was in P&C.

Ramani Ayer

I want to bring this call to a close. First of all thank you all and I hope we have done a good job of answering your questions. I know the IR organization will be available for additional questions. One of the reasons we advanced this call to the evening before is two reasons, one is our call was sandwiched between two others and we wanted to give you the opportunity to have time and the second thing is we know our IR team will be available and given the complexity of the issues we thought it would be better if we had an opportunity to talk to you directly.

I hope this was helpful and we look forward to continued conversations with investors. Thank you again for joining us today.

Operator
Ladies and gentlemen this concludes today's conference. You may now disconnect your lines.