

FINAL TRANSCRIPT

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MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

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Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

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PRESENTATION

Operator

Please be advised that this conference call is being recorded. Good afternoon and welcome to the Manulife Financial Q3 2009 financial results conference call for November 5, 2009.

Your host for today will be Mr. Amir Gorgi. Mr. Gorgi, please go ahead.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Amir Gorgi - *Manulife Financial Corporation - VP, IR*

Thank you and good afternoon. I would like to welcome everyone to Manulife Financial's earnings conference call to discuss our third-quarter 2009 financial and operating results.

If anyone has not yet received our earnings announcement, statistical package, and slides for this conference call and webcast these are available in the Investor Relations section of our website at Manulife.com.

As in prior quarters our executives will be making some introductory comments. We will then follow with a question-and-answer session.

The speakers who follow may make forward-looking statements within the meaning of securities legislation. Certain material factors or assumptions are applied in making forward-looking statements, and actual results may differ materially from those expressed or implied in these statements.

For additional information about material factors or assumptions applied and about the material factors that may cause actual results to differ please consult the slide presentation for this conference call and webcast available on our website as well as the securities filings referred to in the slide entitled 'Caution Regarding Forward-Looking Statements.'

When we reach the question-and-answer portion of our conference call we would ask each participant to adhere to a limit of one or two questions. If you have additional questions, please re-queue as we will do our best to respond to all questions.

With that I would like to turn the call over to Donald Guloien, our President and Chief Executive Officer. Donald?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Thank you Amir, and good afternoon, ladies and gentlemen. Thank you for joining us on this call.

If you turn your attention to slide four in your deck, I will start with an overview of the third-quarter results before turning it over to our Chief Financial Officer, Mike Bell, and our Chief Operating Officer, John DesPrez. I will also have a few wrap up comments at the end before we take questions.

Manulife's underlying earnings, business performance, and asset quality remained strong, but our results for the quarter were impacted by reserve strengthening for lower corporate bond rates and changes in actuarial assumptions. Mike Bell will address the financial results in much more detail in just a moment.

We continue to grow and strengthen our company this quarter. As promised, we took actions to increase margins through higher pricing, adjustments to compensation, and more favorable reinsurance terms. We recorded higher sales across almost all of our product lines with the exception of variable annuity products where we are consciously trying to rebalance our product mix, reduce risk, and improve profitability.

We improved our equity risk profile through a variety of product and asset mix changes and took advantage of rising equity markets to opportunistically hedge a further CAD3.8 billion of our in-force variable annuity business. We now have approximately 30% of our book either hedged or reinsured.

With rising markets, more hedging, and currency changes our net amount at risk dropped by over 50% since the end of the first quarter of 2009. John and Michael speak to these actions and our performance across our operations.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Despite challenging markets, Manulife's credit experience continues to be excellent and our asset quality and our diversified portfolio remain a competitive strength.

We announced two acquisitions that expand our Canadian business -- AIC retail mutual funds and Pottruff & Smith travel insurance. These will grow our existing market positions in Canada and help to balance our overall business mix.

We continue to see an unprecedented number of opportunities for acquisitions across a variety of markets, and I expect that these opportunities will continue. As I have said before, these flow, one way or another, from the financial crisis and I am confident there will be a steady supply of acquisition opportunities over the coming years in addition to the coming months.

Manulife is well positioned with the ability to grow both organically and through strategic acquisitions. We have also remained highly focused on building fortress levels of capital over time to cushion Manulife against the most potential challenging scenarios and help fund growth, including future strategic opportunities. Our MCCSR was strong this quarter at 229%.

We expect to retain additional earnings of approximately CAD1 billion per year as a result of our dividend reduction and dividend reinvestment program.

Looking ahead, we plan to continue to build our scale and strengths, which includes superior asset quality, well-recognized brands, leading products and distribution, excellence in investment management, and strong positioning in key growth markets.

With that I would ask Mike to take us through the financial results. Mike?

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Thanks, Donald. Hello, everybody.

Today we reported a third-quarter shareholder loss of CAD172 million and a fully diluted loss of CAD0.12 a share. Now this quarter's results benefited from the increase in North American equity markets. However, this impact was more than offset by the impact of lower corporate bond rates and reserve strengthening to reflect our annual review of actuarial assumptions.

On slide seven we provide a summary breakdown of the notable items that impacted this quarter's earnings. As noted on the slide, the strong North American equity markets in the quarter resulted in gains of approximately CAD1.2 billion after tax. The negative impact of interest-rate changes in the third quarter also amounted to approximately CAD1.2 billion, essentially offsetting the equity impact.

In the third quarter we completed our annual review of all of our actuarial assumptions. This resulted in a charge to earnings of CAD783 million after tax. CAD469 million of the impact was due to changes in assumptions on policyholder behavior for our variable annuity products and this was consistent with our previously communicated expectations of less than CAD500 million after tax.

The remainder of the charge is due to assumption changes primarily related to other policyholder behavior and morbidity. This was partially offset by favorable assumption changes related to mortality, expenses, and investment-related items. And I will provide some additional detail in a few minutes.

In addition, our investment portfolio continued to perform very well in the quarter relative to overall market conditions. Provisions for credit impairments and reserve strengthening for downgrades were CAD36 million in the quarter. Our equity-related impairments were CAD75 million and were comprised of CAD32 million of other-than-temporary impairments on equity positions in the corporate and other segment and CAD43 million of OTTI on private equity investments.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

The unfavorable impact of the strengthening Canadian dollar from June 30 levels was approximately CAD27 million in the third quarter.

Other items resulted in a charge of CAD33 million for the quarter and were primarily comprised of charges for the reduced value of real estate appraisals, which were partially offset by the favorable impact of tax items, the gains related to the recapture of reinsurance treaties, and a small amount of policyholder experience gains.

So collectively the notable items on this slide totaled CAD975 million of unfavorable earnings impact. Excluding these items our adjusted earnings from operations for the third quarter were CAD803 million after tax.

Now I will go to slide eight which details the impact of equity markets on our results in the third quarter. The S&P TSX and the S&P 500 increased by 10% to 15%, respectively, for the quarter.

Now it's important to note that our earnings benefit of the strong US equity market performance was dampened somewhat by the strengthening Canadian dollar. Of the CAD1.2 billion of net gains related to equity markets, more than CAD1 billion related to the after-tax impact of the release of reserves for segregated fund guarantees. And a portion of these earnings were subject to lower average tax rates consistent with our recent past.

You can see the impact of this in our overall effective tax rate for our consolidated results in the quarter.

Moving now to slide nine. As noted on slide nine, the decline in long-maturity corporate bond rates and spreads resulted in a CAD1.2 billion non-cash charge to earnings. Corporate spreads narrowed by as much as 84 basis points during the quarter.

Now decreases in interest rates impact the actuarial valuation of our in-force block by reducing the future returns assumed on the investment of net future cash flows. I would also point out that our interest rate sensitivity has increased since year end and the increase is due in part to lower interest rates as well as lower long-term lapse assumptions for several of our products.

As shown on the slide, a parallel decrease in interest rates of 100 basis points would have an estimated one-time charge of approximately CAD2 billion at September 30. And this is an increase in sensitivity relative to year-end 2008.

On slide 10 we illustrate the historical movements in various interest rates. And as noted in the chart, during the quarter long-maturity corporate bond rates continued to decline. In addition, spreads continued to narrow and have moved closer towards longer term averages.

On slide 11 we have provided a summary of changes in actuarial assumptions from our annual review completed in the third quarter. The net change in mortality and morbidity assumptions resulted in a CAD260 million after-tax charge to shareholder income. This charge was primarily due to the impact from higher projected net long-term care claim costs in excess of projected prices.

Favorable mortality changes in Japan and the reinsurance division partially offset the long-term care change.

Lapses in other policyholder behavior assumption changes resulted in an after-tax charge of CAD829 million affecting shareholder net income. Over half of this increase, specifically CAD469 million after tax, was attributed to updated lapse assumptions for variable annuities in the US and Japan. And this charge was within our previously communicated expectations of less than CAD500 million after tax.

The balance is due to strengthening of policy liabilities for lower lapse rates for a number of long-duration protection businesses, most notably life insurance in Japan, US, and Canada and the US group long-term care business.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Now partially offsetting these impacts were net favorable assumption changes to expenses, investment returns, and other refinements. Additional detail around the annual review is provided in our MD&A.

In aggregate, changes in actuarial assumptions resulted in reserve strengthening of over CAD1 billion and a negative after-tax impact to earnings of CAD783 million.

Turning to slide 12, after-tax charges for credit impairments and credit downgrades were limited to CAD36 million in the quarter. This was comprised of CAD30 million for net credit impairments and CAD6 million for credit downgrades.

We continue to be satisfied with the current credit performance of our investment portfolio in these challenging market conditions, and we view our asset quality as a competitive advantage. We are also pleased that in the third quarter our below investment grade bond holdings declined modestly as maturities and prepayments exceeded net downgrades.

Now on slide 13 we have highlighted equity-related impairments for the quarter. As I mentioned, in aggregate these impairments totaled a CAD75 million charge to earnings.

Turning now to our source of earnings, which is on slide 14. You can see that expected profit on in-force and earnings on surplus funds together contributed over CAD1 billion to earnings. This result was more than offset by the impact from assumption changes and experience losses that I previously discussed.

Expected profit on in-force increased over the prior year due to favorable currency movements and growth in our in-force business. The impact of new business was higher than the prior year primarily as a result of a lower interest rate environment which particularly impacted our US life insurance business. The net experienced loss reflects the pretax impacts of declining interest rates, which I discussed earlier, which more than offset the equity market related gains.

Management actions and changes in assumptions primarily resulted from our annual basis changes previously detailed and are shown here on a pretax basis. Earnings on surplus funds resulted in income of CAD156 million and include higher realized gains in the quarter. The income tax benefit reflected investment related gains, primarily the equity related ones, being reported in more favorable tax jurisdictions than the investment-related losses.

Now on slide 15 we have provided summary metrics for our reserves and capital in relation to segregated fund guarantees. With a significant rally in North America equity markets in the third quarter the reported amount at risk has decreased from CAD21 billion at the second quarter to less than CAD15 billion as of September 30.

As a result, the expected net gain from guarantees is measured by projected revenue from guarantee fees less projected claims increased from a pretax profit of CAD980 million in the second quarter to a projected pretax profit of approximately CAD1.6 billion measured at September 30.

At quarter end CAD19.5 billion of guaranteed value was being hedged, up from CAD14.5 billion in the prior quarter. We now have approximately 30% of our gross guaranteed value either reinsured or hedged, and this is an increase from 20% at year-end 2008.

Now slide 16 provides an updated estimate of earnings and capital sensitivities going forward. From a consolidated earnings perspective we estimate that a one-time equity market correction of 10% followed by normal market growth at assumed levels would now reduce reported earnings by approximately CAD1.3 billion after tax. We observed decreasing sensitivity is largely due to the lower in-the-moneyness of these exposures.

In terms of regulatory capital, MLI's reported in MCCR was 229% at quarter end. We estimate that a 10% equity market correction could result in a decline of approximately 15 points in this ratio as of September 30.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

As summarized on slide 17 our investment portfolio continues to be high quality and well diversified. Our portfolio is performing relatively well in the current downturn with 94% of our bonds being investment grade and highly diversified by geography and sector.

We have also provided on slide 18 an update on gross unrealized losses on our fixed-income securities. You can see the progression over the last three quarters illustrates continued, significant improvement. At September 30 we had a net unrealized gain on our CAD107 billion fixed income portfolio, and due to general spread narrowing gross unrealized losses declined over 50% sequentially to CAD2.5 billion and represent a relatively modest 2.4% of our total fixed income portfolio.

In addition, unrealized losses for our fixed income portfolio trading at less than 80% of cost for over six months declined by 33% since the second quarter to CAD1.4 billion. This favorable change is primarily due to market improvement and also the appreciation in the Canadian dollar.

Now we have the ability to hold these securities until maturity and have provided for expected levels of defaults in our actuarial reserves. Based upon our performance to date and our lower level of gross unrealized losses, we believe that our asset quality represents a significant competitive advantage.

Slide 19 provides a summary of our expectations of adjusted earnings from operations for the remainder of 2009 and 2010. Our expectations are based upon our book of business and currency levels as of June 30, 2009, and include approximately 2% per quarter equity market appreciation and no unusual interest rate movements.

On this basis plans last quarter we estimated normalized earnings of CAD750 million to CAD850 million after tax per quarter for the remainder of 2009 and 2010.

Now to be clear we are not providing earnings guidance, particularly since no one can predict near-term market conditions with confidence, and adjusted earnings are not the same as GAAP net income. Our current estimates would imply an adjusted ROE of approximately 12% with our longer-term objective being a higher ROE over time.

As noted on slide 20, there are a number of items excluded from our definition of adjusted income from operations which may positively or negatively impact net income. These may include such items as underlying business growth, including potentially increasing fee income from asset growth; potential policy related experience gains and losses, such as mortality, morbidity, and lapse experience; investment and market-related gains and losses. These can arise from investment management performance, moves in equity markets, and changes in interest rates. And in the current challenging economic environment credit losses and impairments could be higher than our long-term assumptions.

Other items include higher or lower prices and margins in the future on insurance and wealth management products; new business mix changes; lower or higher operating expenses; the potential for accretive acquisitions; and favorable or unfavorable currency movements.

So, for example, the weakening of the US dollar reduced third-quarter earnings by CAD27 million relative to our June 30 assumptions for normalized earnings. If the current exchange rate continues into the future, we would expect this impact to persist.

Now turning the discussion to capital on slide 21. As we have previously described, our goal is to have the financial flexibility to weather many, but not all, potential adverse scenarios without being forced to raise common equity under stress conditions. We also want to have more flexibility to respond to both risks and opportunities from a continued position of strength.

We continue to believe that companies with strong financial strength ratings and capital ratios will benefit from a flight to quality.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Now on slide 22 you will note that MLI's third-quarter consolidated MCCR was 229%. We view this as strong and it is up significantly over the prior year. The sequential decrease in the MCCR primarily reflects the impact of lower corporate bond rates and our annual review of actuarial assumptions, which more than offset the impact from improved North American equity markets.

Our current MCCR position provides us with a significant buffer relative to the regulatory target of 150%. In addition it's important to note that we currently have CAD1 billion of contingent capital at the holding company level which can be down streamed if required.

Slide 23 provides an update on our process of reorganizing our US subsidiary structure. As we have previously communicated this involves the merger of our John Hancock Life Insurance and our John Hancock Variable Life Insurance subsidiaries, which currently reside under our MFC holding company, into our John Hancock USA subsidiary, which resides under our MLI subsidiary.

Pending regulatory approvals, we anticipate that the reorganization will be completed by December 31 of this year.

Now there are a variety of benefits associated with this reorganization as outlined on slide 24. Most notably, once the reorganization is completed we will have a more efficient capital structure, a more diversified risk profile, more stable capital ratios, and reduced administrative costs.

We expect that the pro forma MLI MCCR ratio will decline upon the merger by approximately 15 points. But importantly we will maintain a comparable equity market correction buffer relative to the regulatory target of 150%.

Now in the future our overall MCCR sensitivity to equity markets will be lower after the legal entity merger. In addition, on a post-merger basis we estimate that our pro forma RBC ratio would be in excess of 300%.

So, overall, our underlying earnings for the quarter were strong. However, as anticipated net income was impacted by lower corporate bond rates and spreads as well as the charges associated with our annual end-to-end review of actuarial assumptions. These items more than offset the impact from a strong equity market performance in North America.

Moving forward we are well-positioned to profitably grow our underlying businesses.

With that I would like to pass it over to John who will provide an update. John?

John DesPrez III - *Manulife Financial Corporation - COO*

Thank you, Mike, and good afternoon.

The main topics that I will cover today include our strong operating results, our continued progress on reducing equity risk exposure, and recently announced acquisitions. Overall sales of non-variable annuity products have been strong despite the weak economy. We believe this is evidence of the strength of our brand and a growing flight to quality in the market.

On slide 26 insurance sales have experienced sequential increases over the prior two quarters across most business segments and ended the quarter 2% higher than prior-year levels on a constant currency basis with solid advances in Asia and Canada being offset by a decline in the United States.

Overall, US sales improved by 18% over the prior quarter but were down 6% over the prior year with both life and long-term care experiencing significant improvements over the prior two quarters but falling short of prior-year levels by 4% and 13%, respectively. Despite general economic trends, life sales topped CAD200 million in the quarter and long-term care sales were robust compared to strong prior-year comparables.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Since the end of the first quarter life has introduced stronger pricing on its term and universal life offerings, while long-term care has increased pricing on its group segment. In Canada overall sales increased by 6% from prior-year levels. Group benefit sales experienced robust growth of 12% as a result of impressive large case sales which were partially offset by a 2% decline in individual insurance sales.

Asia experienced record sales during the quarter with overall sales exceeding the prior year by 16% on a constant currency basis. Japan sales were up 22% or 7% on a local currency basis, while Hong Kong sales increased by 29% with strong sales momentum bolstered by new product offerings and distribution initiatives. In addition, substantial advances in market share in 2009 were reported by Japan and Indonesia reflecting consumer flight to quality.

China sales also continued to grow, up 18% in the quarter reflecting contributions from new offices opened in the prior year as well as recent marketing efforts. During the quarter Manulife continued to expand operations in China receiving an additional license in the province of Tianjin, bringing the total number of licenses up to 38, among the most of any foreign life insurance company in China.

Turning to slide 27. Wealth sales excluding variable annuity products increased by 4% over prior-year levels on a constant currency basis driven by fixed return product sales in the United States and Canada, which continued to outpace prior-year levels resulting from consumers seeking stable investment returns.

In the United States wealth sales, excluding variable annuity products, improved by 21% over the prior quarter and were in line with prior-year levels. All non-variable annuity segments experienced double-digit growth over the previous quarter with fixed return product sales up 16%, pension sales up 30%, and mutual fund sales up 18% over the second quarter of 2009.

In comparison to the prior year, fixed return product sales were up by 37%, retirement plan sales were flat, and mutual fund and other sales were down 12%.

In Canada wealth sales, excluding variable annuity products, increased by 5% over prior-year levels, bolstered by impressive growth in fixed products and group retirement which more than offset declines in Manulife bank loan volumes. Fixed product sales increased by 51% over the prior year, while group retirement sales more than quadrupled prior-year levels driven by record sales of group annuities. Year to date group retirement sales exceeded CAD1 billion, reflecting strong results in the defined contribution market.

In Asia, wealth sales excluding variable annuity products increased by 59% versus the prior year, driven by strong growth in Indonesia. Indonesia fund sales more than tripled benefiting from the equity market recovery. Variable annuity sales were less than half of prior-year as a result of ongoing risk management initiatives across all geographies.

Turning to slide 28, premiums and deposits. Excluding variable annuity products we are CAD14.3 billion for the quarter, a decrease of 2% over the prior year on a constant currency basis. Growth of in-force insurance business and higher sales of fixed return wealth products were offset by lower new mandates in the institutional advisory business.

Variable annuity and segregated fund deposits of CAD1.9 billion declined by CAD2.1 billion as a result of our ongoing risk management initiatives across all geographies.

On slide 29 new business embedded value, excluding variable annuities, was CAD588 million during the quarter, up 4% over the prior year. Insurance new business embedded value was 17% higher than prior-year levels driven by growth across all geographies, while wealth new business embedded value was down 48% reflecting lower variable annuity sales, hedging costs, and other product mix changes.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

As shown on slide 30, total funds under management as at September 30, 2009, were CAD437 billion, an increase of 13% over the prior year as a result of net positive policyholder cash flows of CAD20 billion and favorable currency movements. Over the last four quarters investment returns have contributed approximately CAD19 billion to the increase.

The growth in funds under management also includes CAD3.8 billion from the acquisition of AIC Ltd.'s retail investment fund business.

Moving to our efforts on further reducing our equity risk exposure, slide 31 summarizes our strong progress in this regard. During the third quarter we opportunistically hedged CAD3.8 billion of Canadian in-force business, in addition to the new business written in the quarter. Substantially all new business in the United States and Canada continues to be hedged on an ongoing basis.

In total CAD19.5 billion of guaranteed value is currently being hedged with a corresponding CAD1.6 billion of net amount at risk. We also continued to implement changes to our product offerings by altering product features, increasing margins on new products to ensure profitable business after hedging costs.

In Canada we introduced a new segregated fund platform and closed legacy products providing a more streamlined suite of products with reduced product features, lower equity content, more index funds to improve hedging effectiveness, and higher fees.

As noted on slide 32, our risk exposure on equity guarantees has decreased significantly due to increased hedging and recovery in global equity markets. At quarter end our net amount at risk was CAD13.3 billion, down significantly from year-end 2008. In all we are now hedging or reinsuring 30% of the gross guaranteed value as at September 30, 2009, up from 20% at December 31, 2008.

Turning to slide 33, we have continued to capitalize on strategic acquisition opportunities. During the quarter we announced and completed the acquisition of AIC's Canadian retail investment fund business. This transaction added approximately CAD3.8 billion of assets under management and increased our scale by approximately 40%, bolstering our presence in the retail investment fund market.

Subsequent to the quarter end we also announced the acquisition of Pottruff & Smith Travel Insurance Brokers Inc., one of the largest travel insurance brokers and third-party administrators in Canada. This acquisition solidifies Manulife's position as one of Canada's largest providers of travel insurance with a stronger platform for long-term growth.

We continue to be presented with a wide range of acquisition opportunities which are currently being investigated.

With that, I will turn it back to Donald who has some closing remarks.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Thank you, John. If you turn your attention to slide 34, we have got a wrap up. I would like to wrap up a few comments before we open up to your questions.

Our actions this quarter are consistent with the priorities you have heard us outline before. We are growing our businesses with a priority on the highest return products and geographies and diversification of risk.

We are taking advantage of a flight to quality. We are reducing our equity sensitivity through the derisking of products, through structure, and through hedging. We are taking steps to increase margins, charging more for taking risk and offering quality that consumers value.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

We are growing sales by extending our product offerings and leveraging our skills, particularly in all elements of savings and investment management. We are seeing unprecedented opportunities for acquisition and geographic expansion, and we have remained highly disciplined as we move on some of these.

We are leveraging our skills and building upon our scale and strengths, which include strong asset quality, excellence in investment management, well-recognized brands, leading products, and excellent positioning in key growth markets. And, finally, we remain focused on building toward fortress capital levels that will help to cushion us against potential challenging scenarios and fund growth including future strategic opportunities.

Overall, we remain on track and I remain very optimistic about Manulife's future.

Operator, that slide was going to conclude our remarks. However, we just became aware that a newswire has been issued by Standard & Poor's. And rather than lose our audience to their Blackberrys and computer terminals I would like to ask Mike Bell to address the Standard & Poor's announcement.

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Thanks, Donald. Again, we were just informed that S&P did issue an announcement on Manulife. Admittedly, I do not actually have the actual release right in front of me, but I want to make some comments based on a draft that I had seen earlier this morning on the assumption that it did not change materially.

There are really three points in the S&P release that are worth highlighting. First and most importantly, we are really pleased that the operating company ratings for our company are unchanged at the AA+ level.

Now we are really proud of the AA+ rating. It's a competitive advantage for us against all of our main benchmark competitors. It's really important to us because it supports our brand out in the marketplace. It helps promote our brand of having financial strength out in the marketplace, which is very helpful. So that to us is the most important piece.

Now, second, it is also noted in the release that they have changed the -- S&P has changed the operating company outlook from stable to negative. And given that rating agencies have been reasonably pessimistic on the life insurance industry and particularly pessimistic as it relates to equity market exposure, given that we have got some of that and obviously are in the life insurance industry, I think that is the primary driver of the change to a negative outlook.

The third item that was referenced in the release is the holdco. Currently we have a AA- rating for our holding company, and my understanding is that has been changed to credit watch negative.

I would point out that S&P has a standard notching protocol of having three notched differences between the holding company and the operating companies. Manulife obviously has enjoyed and appreciated being a positive outlier and having only a two notch difference between the holdco and the operating companies; AA- versus AA+.

If in fact the holding company does ultimately get downgraded and we are back to the standard -- we would be back to the standard notching. So we believe that would be a manageable outcome if it happens, although obviously I am disappointed in it.

And I do believe that the comments around the legal entity merger are inconsistent with our own views. Our own view is that the legal entity merger in the US actually strengthens our capital position.

So that in a nutshell is the S&P release. Again, overall most importantly we remain AA+ at the operating company level. That is a competitive advantage for us and in fact very important. At this point I think we are opening it up to Q&A.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Tom MacKinnon, Scotia Capital.

Tom MacKinnon - Scotia Capital - Analyst

Thanks very much; a couple questions. First, with respect to the interest rate hits that we have seen, is the fact that some of these loan yields sort of picked up right now that interest rates have sort of picked up a little bit since the end of the quarter, would it be -- could we actually say that maybe we are at the end of the road in terms of interest rate hits going forward in terms of reserve development there?

And then I have a question with respect to the hedging, the CAD3.8 billion that was hedged in the quarter. What was the cost of that, if that can be disclosed, and what was sort of the cost in terms of actually all the hedging that you have done so far this year? Thanks.

Mike Bell - Manulife Financial Corporation - SVP & CFO

Great. Hi, Tom, It's Mike. I will start with the first question. Your question on interest rates, obviously it's useful to have interest rates rise. We are obviously pleased that the long bond rates have increased since September 30.

Whether this is the end of the road of drops in interest rates and compression on spreads, I think is anybody's guess. But certainly that movement since September 30 is useful and would certainly help us in the future. But, again, one month not necessarily a future make but certainly a positive trend.

Tom MacKinnon - Scotia Capital - Analyst

Now when you set the reserves do you use the rates that were in effect at the valuation date? Is that correct or what kind of leeway do you have?

Mike Bell - Manulife Financial Corporation - SVP & CFO

Tom, that is correct that we use the rates as of the valuation date. Now again based on the Canadian actuarial practices, we also over time use an ultimate reinvestment rate. But the major driver is the rate as of -- the rates and spreads as of September 30 for the valuation.

Tom MacKinnon - Scotia Capital - Analyst

Okay. And then with respect to hedging?

Donald Guloien - Manulife Financial Corporation - President & CEO

I am going to ask Bev Margolian to answer that, Tom.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Bev Margolian - *Manulife Financial Corporation - EVP & Chief Risk Officer*

Thanks. When we hedged the business we are hedging it using a dynamic hedging strategy, so we don't know the locked in cost upfront. It's important to know that.

What we estimate based on what we assume to be realized volatility going forward that we will be able to have hedged this business to maintain a healthy profit margin after the cost of hedging.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

So we look to make approximately 50 basis points from issue on the business, Tom. That is what we look to and we basically --we did not -- I got a lot of advice when I assumed the helm to hedge the whole business out and put it behind us and we didn't do that. We wait for equity markets to go up on each cohort of business and when we can lock in something like a 50 basis point profit from issue, we hedge it from there.

Tom MacKinnon - *Scotia Capital - Analyst*

But there wasn't any kind of one-time charge that you have been able to determine as a result of putting an in force hedge on in the quarter?

Bev Margolian - *Manulife Financial Corporation - EVP & Chief Risk Officer*

No, there is no one-time charge. We basically execute or execute short some futures and put on some lengthening interest rate swaps and neither of them incur charges upfront. It really just depends on the settlement costs based on the interest-rate movements and the equity market movements going forward.

Tom MacKinnon - *Scotia Capital - Analyst*

Okay, thanks for that.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

So, Tom, there would be some modestly lower earnings expected going forward because, again, the margins post-hedging would be somewhat lower than pre-hedging on an expected basis. Obviously the reduction in the equity sensitivity though is very useful and hence why we took the action.

Tom MacKinnon - *Scotia Capital - Analyst*

And the reduction in the sensitivity to both equity markets and capital is that a function of hedging or is that a function of increased equity markets?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

It is a function of increased equity markets, Tom. It is a function of hedging; it is also a function of currency frankly.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

But certainly primarily --

Tom MacKinnon - *Scotia Capital - Analyst*

How would you rank them?

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Essentially in that order. Again, because of the convexity of the liability curve with equity markets having improved, that reduces our sensitivity.

Tom MacKinnon - *Scotia Capital - Analyst*

Okay, thanks.

Operator

Jim Bantis, Credit Suisse.

Jim Bantis - *Credit Suisse - Analyst*

Good afternoon. Two questions, I'm looking at your slide 11. You've shown some disclosure with respect to the policyholder behavior coming in at roughly CAD130 million. Can you give us some color in the context of what type of change in lapse rates you have forecasted or made changes in assumptions just so we can get a sense is this issue by and large behind us now?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Jim, I'm going to turn that over to Simon Curtis.

Simon Curtis - *Manulife Financial Corporation - EVP & Chief Actuary*

Jim, it is Simon speaking. As Michael mentioned, about half of the increase was on our variable annuity businesses that we had talked about at the second-quarter call. In those products what we were not changing was the long-term lapse rates, but more the speed with which lapse experience adjusts to how perceived contracts are to be in the money.

So I can't actually give you any sort of hard statistic on that, but basically the adjustment on the variable annuities was really assuming that lapse rates would go down more quickly. As contracts became more in the money, the guarantees were perceived to be more valuable.

The other half of the basis change increase was really on insurance businesses, and it was in four business groups geographically split and basically different product lines. So four businesses had between CAD100 million to CAD200 million increase each. In Canada there was an increase on some of our par lines, which -- where we took our lapse rates down below 2% long term.

In the US the lapse adjustment was primarily on long-duration universal life contracts where we reduced the ultimate lapse rate so that now they are actually basically between 0% and 1%. We had an adjustment in our group LTC business in the United



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

States which took the lapse rates there down to -- actually I don't have that one right in front of me, but I believe it would be down in the 1% range there as well.

And then, finally, in Japan we had some adjustments on our universal life business which were sort of mid duration lapses to reflect the experience there. No adjustments to the long-term lapse rates.

So you can see -- as we mentioned at previous calls where we are seeing sort of changes in policyholder experience it's not confined to one geography or one product line. It's just a systemic change in policyholder behavior that we are viewing over time. Each year when we update the basis changes is when we sort of see that coming through in a capitalized way.

Jim Bantis - *Credit Suisse - Analyst*

Thank you, Simon, for that detailed response. It sounds like from some of the lapse rates you quoted that it would be highly unusual to see the lapse rates falling much further? Or are you requiring substantial adjustments to these reserves?

Simon Curtis - *Manulife Financial Corporation - EVP & Chief Actuary*

Yes, I think these -- one comment I can make is that we are very proactive in trying to update for where lapses are and as a result we have taken our lapse rates to low levels. We can't sit here and say we would never see adjustments again, but we are pretty confident that we are very on top of and proactive in capturing the lapse experience.

Jim Bantis - *Credit Suisse - Analyst*

Thank you. Now --

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Jim, this Don Guloien here. I just wanted to interject. These are uncomfortable changes to make but it's the strength of the Canadian accounting process that forces people to confront these things in a very dynamic way. We have obviously strengthened our reserve basis for these. Only time will tell whether they are necessary, but the approach requires us to confront them as we see them coming.

Jim Bantis - *Credit Suisse - Analyst*

Don, along those lines when you talk about the conservative nature of the assumptions and then earlier there were comments about the asset quality, do you view these two issues to be some of the challenges that potential acquisitions will have going forward? Like, when you think of the potential targets that you are looking for will these be the kind of catalysts that we have all been waiting for for these companies to have to embrace at some point?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Well, as I said before, Jim, there is a lot of companies that are in fairly tough shape and that is shaking loose a lot of opportunities. And we intend to be there to receive them. That is the goal of the Company, plain and simple.

We have done very well on that type of activity in the past and I think, quite frankly, the opportunities have never been better than they are today.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Jim Bantis - *Credit Suisse - Analyst*

And just a last question for John DesPrez; CAD771 million of VA sales is still a sizable run rate even though coming off of substantial highs in the previous year. John, when we think of the ROE that is being expected from these new VA sales, what should we be thinking about? Are you pricing it at a 15% rate?

John DesPrez III - *Manulife Financial Corporation - COO*

Let me let Hugh McHaffie, who is directly responsible for the VA business, respond to that.

Hugh McHaffie - *Manulife Financial Corporation - EVP, John Hancock Wealth Management*

In regards to pricing targets, Donald had already mentioned that our goal is to hit a 50 basis point spread of managed assets after hedging. And through the fourth quarter we are, on a long-term basis, relatively hitting that and those numbers are hitting our pricing and targets in terms of ROE.

Now we are very comfortable with the 700-and-some-odd -- \$700 and three-quarters of a billion of sales in regards to profitability. The changes we have made for derisking the product of -- we have taken some fairly substantial changes to push down the bonus deferrals, change expenses, change asset mix. That has all come together and a very comfortable block of business.

Jim Bantis - *Credit Suisse - Analyst*

Hugh, just -- okay, so I am just trying to kind of capture this from an ROE perspective. And maybe it sounds like it's difficult to do so, but you are quoting the 50 basis points. Maybe you can give me a sense of what the spread was pre-crisis?

Hugh McHaffie - *Manulife Financial Corporation - EVP, John Hancock Wealth Management*

In the first quarter clearly with the cost of hedging being higher it would have been much lower than that and that facilitated the change in the product. In terms to -- on an ROE basis it's north of 15% return on equity on those products.

Jim Bantis - *Credit Suisse - Analyst*

Thanks very much. I will re-queue.

Operator

Steve Theriault, Bank of America-Merrill Lynch.

Steve Theriault - *Bank of America-Merrill Lynch - Analyst*

Thank you. Two questions; firstly, a new item or what I think is a new item in the notes that I noticed that references goodwill testing and mentions the repositioning of your VA business. So how much goodwill is backing the VA business and would you be prepared to comment on the likelihood, timing, or magnitude of any potential impairment going forward?

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Secondly, just a follow-up on Tom MacKinnon's question on hedging. If you are trying to lock in a targeted margin, does that mean that additional hedging becomes likely or, sorry, that additional hedging is unlikely if equity markets stay roughly where they were at the end of the third quarter? Thanks.

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Okay, I will start on the goodwill question. First of all, we view it as very good financial disclosure to add that to the quarterly disclosure, so I would suggest that you not overweight the importance of the point.

But to answer your question, we have CAD1.9 billion of goodwill today backing our US wealth management business. And we simply wanted to note that since we are obviously repositioning the VA business, repositioning our VA sales for the future, we are cognizant of the fact that that could have some impact on goodwill.

We do a very thorough goodwill review each year. We would do that as scheduled in the fourth quarter and as we wrap up our 2010 business plan that would get factored in to the goodwill testing as well.

So at this point I wouldn't try to predict where that is going to come out, but to me it was good disclosure to at least highlight it as something on the radar screen here for the fourth quarter.

On the hedging piece, I will start and I will see Donald or Bev want to add. Again, at this point we are evaluating a wide range of potential hedging scenarios. I think it's fair to say that we would be more inclined to expand the hedging program as markets go up. But, again, at this point we are still reviewing that and wouldn't try to add more specificity at this point.

Steve Theriault - *Bank of America-Merrill Lynch - Analyst*

Okay, thank you.

Operator

John Reucassel, BMO Capital Markets.

John Reucassel - *BMO Capital Markets - Analyst*

Thank you. Just a quick question, back to slide 11 and I am just a little confused. You have a positive contribution from basis change on investment returns, yet we talk about how low rates are and everything else. Can you explain to me exactly what is that valuation basis changes that you are expecting higher investment returns on?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

I will let Simon respond to that one.

Simon Curtis - *Manulife Financial Corporation - EVP & Chief Actuary*

Sure. Yes, that investment return category captures a number of things, John. As in all these categories there are offsetting items since we are reviewing all of our assumptions and methods.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

The first thing that generated some strengthening were the review -- we reviewed our stochastic parameters for our variable annuity reserving. And as you could expect there was some increase in some of our assumption from our assumption review there, because we were reflecting some update to return and volatilities.

There was a modest increase as well from updating the ultimate reinvestment rates under the Canadian standards but they got offset. We had a net release when we started also updating our models for a sort of fundamental review we have been doing all year on our modeling of reinvestment strategies under Canadian GAAP to make sure they align with what we actually have in our investment policies and such.

We are required to make sure that the investment strategies and the valuation reflect what we actually plan to do in executing those strategies. And that actually led to a release from that I know which overall drove the negative release -- excuse me, the valuation release. But we did have some strengthening as you would expect and I think is what you were getting at related to long-term interest rates and stochastic parameters.

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

John, it's Mike. The only piece I would add is that last item that Simon mentioned relates to our long-term care business and I would just add that on a net-net basis we did strengthen reserves for long-term care.

John Reucassel - *BMO Capital Markets - Analyst*

Okay. I might have to come back on that, but thank you. The other question I had is just trying to understand this interest rate risk. I understand on equity market risk you can go out and it maybe expensive or whatnot to hedge that risk, but you can't hedge interest rate risk, can you?

I mean, this is fundamental to the business model so as rates -- if rates go lower it's just a tough environment to grow earnings. Is that a fair statement or is there a way to offset that?

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Well, John, you are essentially right. What we hope to do it is to [inaudible] our liabilities with a selection, a diversified selection of corporate A bonds on average with some other investments. You can hedge treasury rates but you can't hedge corporate rates going (technical difficulty) 20 years.

So the issue we have is a valuation issue. We make assumptions about how much we are going to earn on a premium that comes in year 20. And, yes, we could hedge forward on the underlying treasuries, but we can't hedge the spread that we expect to earn unless we are going to do some wild and crazy credit derivatives. And you can imagine our attitude towards that.

So in the meantime, we take a big valuation hit on the underlying assumption that rates will stay as low as they are for a very long period of time, both the underlying treasury yield and the corporate spread. If you believe that North America is going the direction of Japan that is probably not conservative enough.

If you belief like most of us in the room do and I suspect the people on the call do, that interest rates will go up, both the Treasury rates for a whole bunch of reasons and spreads, we will have quarters in the future where the outcome will have a very positive sign associated with it.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

John Reucassel - BMO Capital Markets - Analyst

Okay, great. And then just last, just to be clear on the new merged MCCR at MLI, the new consolidated, can you give us a sense -- right now the equity market movements on 10% plus or minuses, plus or minus 15 points. So on the new merged MLI in Q4 '09 what would the sensitivity be there? Is it half that or is it a little less than that? Could you give us some sense?

Mike Bell - Manulife Financial Corporation - SVP & CFO

Sure, John. Not to sound overly precise, it's approximately 11.5 points. So it's 3.5 points less than the 15 based on the current pro formas. Now, again, the actual number we got to get through the year end to complete the legal entity merger itself. It may move around a little bit, but at this point the pro forma number is 3.5 points less.

John Reucassel - BMO Capital Markets - Analyst

Thank you.

Operator

Michael Goldberg, Desjardins Securities.

Michael Goldberg - Desjardins Securities - Analyst

Thanks. Okay, I was going to ask about the interest sensitivity, but I think that that is covered. So I am going to go to slide 29 and your new business-embedded value where I think that you said that excluding variable annuities it was CAD588 million this quarter, which implies that just on variable annuities alone CAD68 million seems to look something like about a 3.6% margin on VA sales.

So what I would like to know is this a reasonable way to look at it? And as you restructure and reprice your variable annuity product would you expect that that margin is going to go up, down, or sideways?

Simon Curtis - Manulife Financial Corporation - EVP & Chief Actuary

It's Simon here, Michael. I think what you are doing is you are sort of taking that new business embedded value that we have come up with and trying to take a ratio of that to sort of what we have reported as the premiums.

I think that --it is a useful metric. I can't actually vouch for your math because I haven't actually done the calculation myself, but I think it would be one way to look at the profitability. Obviously that new business embedded value if you are writing at higher margins it should go up as a proportion of your premiums and down if you are writing at a lower margin.

In terms of the profit outlook on VAs going forward, I don't know -- John or Hugh?

Hugh McHaffie - Manulife Financial Corporation - EVP, John Hancock Wealth Management

Embedded in that new business embedded value calculation is the cost of hedging so it will depend upon the variability of hedging costs over time. So I think you will just see that move around as the cost of hedging moves around on the new business.

I haven't done the math either so, Simon, I can't vouch really for your specific math.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Donald Guloien - *Manulife Financial Corporation - President & CEO*

But, Michael, I think where you are going is the new business embedded value on the VA business before it was a lot higher when it was on an unhedged basis. Obviously we don't find that a good way to continue so we are hedging the new business. That reduces it on a unit basis enormously.

I think the broader question you are asking is the business sufficiently profitable to justify the capital allocation. And we think it is, but I have said it before we should all in the industry be charging more for this. We are taking a leadership position with some of our product designs and changing prices.

But I guess this stuff on the US statutory basis throws up profits and issue I think. A lot of companies are enamored with writing more and more of it so there is still a little bit more price competition going on than I think is perhaps appropriate in the market. But that is what markets are for, everybody taking a different view.

We are trying to balance the sales of it and trying to ensure that what we are selling is profitable with a high balance of probability in favor of our shareholder.

Michael Goldberg - *Desjardins Securities - Analyst*

Okay. And on another topic, it looks like given OSFI's comments recently that we are safe in retaining CALM at least until we get to phase two of the implementation of IFRS. And my question is -- are you doing anything, can you do anything, to ensure or to get more allies on the side of retaining CALM?

Because it seems to me like if CALM disappears either you are -- the way you manage investments changes or all hell breaks loose.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Michael, we couldn't agree with you more. The Canadian accounting regime, as I said earlier, forced companies to deal with problems earlier than they would otherwise do. And is a very intelligent regime that promotes matching of assets and liabilities very effectively and penalizes people for not doing that or where it's unable to do that.

The historical direction of IFRS was sort of disassociate the two and could result in some difficult outcomes. I think we are getting more and more allies around the world on that, not just the Canadian basis. There has been discussion in our industry and I think our regulator understands the issue.

But more importantly perhaps is on a foreign basis a number of countries and companies in various places in Europe are starting to recognize that some of the proposals inherent in IFRS aren't necessarily that sensible. And I think there is going to be some rethinking of it from its original premise.

Michael Goldberg - *Desjardins Securities - Analyst*

Can you give me some examples?

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Well, they have had proposals about discounting all reserves at the risk-free rate for instance. That would not be a very bright thing to do. The consequence of that would mean that people around the world -- nobody would be able to buy any products with any long-term guarantees at all.

So when you have got people everywhere in the world worried about how they are going to live with pension plans, both government and company-sponsored declining, I can't imagine it would be good government policy to take away the last bastion that people can go to, which is life insurance companies offering things like life annuities and pension buyouts, that that would be an intelligent thing to do from a public policy standpoint.

But if everybody discounted everything at the risk-free rate you can imagine what that would do to pension plans around the world. So that is one proposal that is easy to attack. There are already signs that they are moving in a very positive and intelligent direction there.

But it's not our company or our country; it's a number of companies around the world, very large and sophisticated companies. And it's also some governments that are saying we have to intervene on this stuff to make sure it lands in a sensible place.

Michael Goldberg - *Desjardins Securities - Analyst*

Thank you.

Operator

Eric Berg, Barclays Capital.

Eric Berg - *Barclays Capital - Analyst*

Good afternoon, Don, and to your team. Don, I am looking at the S&P news release and to me at least the Agency seems to make very clear why they will very likely downgrade Manulife. I quote, 'Manulife's risk tolerance remains high and the majority of its equity-linked liabilities remain unhedged.'

They seem to be saying -- I can't get into their head for sure -- but they seem to be saying that they don't like your threshold decision not to hedge the entire book all at once. I know you have been through it, but can you remind the audience.

Given that the cost of hedging is more than it was before the crisis but down dramatically from where it was at the peak and given too the extreme upheaval that Manulife went through, why have you made the decision that you have made not to put this issue behind Manulife and buy hedges for everything now?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Well, Eric, that is a great question. I think it would not be in the shareholders interest. I have said this before in the public eye and I will say it now, it would be in Don Guloien's interest. I mean, I can look like a hero of a huge one-time charge and say we put it behind us. And I think that would mollify rating agencies and other people who are concerned about the downside risk.

If we had done that back in March and compared with where we are today we have made billions of dollars by not doing that. You can see that as markets moved up we opportunistically moved in and hedged for a very significant gain for the shareholder.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

I happen to believe that the shareholders who have suffered a great deal by seeing the unhedged positions' cost in terms of the market downdraft have a right to earn that back in the market updraft. And I am not prepared to put their interest behind me because of a rating agency has a view on the unhedged position.

I think their view is fair that it exposes us to risk, but we have tried to be very open about the amount of risk that we have. We think the majority of shareholders will commend us.

If the market were to go down to 650 in the next couple of weeks, I think people would say that was a very dumb decision. But if the market goes up and down as it's want to do and slowly recovers over a period of years or a period of months, whatever, I think people will commend the decision. So far it has served us very well to take a cautious approach and we intend to follow that approach going forward.

Eric Berg - Barclays Capital - Analyst

Okay, that is responsive and I appreciate it.

My second of three questions; I will try to go quickly so that others can have a chance too behind me. Turning to slide 19, I would like to get a sense from you folks this is essentially what you told us at the end of the June quarter.

So by placing this slide here now at the end of the September quarter are you essentially affirming the guidance that you -- not guidance, but I know you were careful -- I know Mike Bell was careful not to refer to it as guidance. But in reprinting a slide for information that you provided at the end of the June quarter what should we infer from that?

Mike Bell - Manulife Financial Corporation - SVP & CFO

Eric, it's Mike. I think you should infer that we remain committed to the comments that we made at second quarter and that we reaffirmed today. And that is that we do expect the normalized earnings, as we have defined it, to be in that range.

Now as I said in my prepared remarks, there are all sorts of pluses and minuses not contemplated in our definition of normalized earnings. A couple that I highlighted, credit conditions. While our credit results have been a real competitive strength, credit conditions generally have been negative and also just a clear area of uncertainty.

So the point is the normalized earnings are based on long-term expectations. Near term that would be an area where I would expect to have some pressure. I don't think there is a way to quantify it, but there is clearly pressure.

The same thing with currency. Obviously the weakening of the US dollar versus June 30. Since the normalized earnings are based on the \$1.16 exchange rate as of June 30, the weakening of the US dollar also is a headwind in terms of the normalized earnings. But, again, given that all of that stuff is out of the definition of normalized earnings we continue to believe that for the remainder of 2009 and 2010 that is an appropriate expectation.

Eric Berg - Barclays Capital - Analyst

Last question to Mike and I think this will be fairly easy for you, Mike. Page seven of the slides references a CAD1.2 billion hit related to interest rates, and then on slide 11 you are enjoying a benefit of CAD314 million related to interest rates.

I know you were discussing this earlier, but what is the -- maybe you could build on your earlier response -- what is the difference between those two numbers, not arithmetically but in concept. They are obviously dealing with different topics.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

And could you just go over -- you just went a little bit too quickly for me -- why is one number going in one -- have a negative sign associated with it, it was a hit to earnings, and one is a benefit to earnings? Thank you.

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Sure, Eric. First, in terms of the CAD1.2 billion hit to earnings from interest rates. As we have talked about in the past, there are a lot of different factors that impact that but most importantly, as Donald reaffirmed here today, the drop in corporate bond rates and the further compression in spreads hurts our earnings. And that is really a normal phenomenon for most life insurance companies these days.

And so -- I can't give you a specific formula or a specific single interest rate to look at, but the phenomenon here is that CGAAP accounting rules require us to present value all future premiums and all future claims. So, again, as we have to make a modeling assumption around what interest rate are we going to invest a premium that we are going to get 20 years from now.

And so given that we had to do all of that in the present value formula, when we are in a situation like we are in now where corporate bond rates drop, the assumed interest rate on what we are going to invest that 20-year premium, 20th year premium in also drops. So we have got that phenomenon.

The other piece that impacts our earnings is spreads. Again, we have reduced our interest rate sensitivity for several of our products by entering into swap arrangements that synthetically lengthen our assets. Again, that is helpful in that it reduces our interest rate sensitivity.

Unfortunately, we are not able to achieve the traditional corporate spreads when we enter into those swaps, so we are also susceptible to corporate bond rates coming down. The bottom line here is that corporate bond rates as well as spreads moved against us in the quarter, and that was worth approximately CAD1.2 billion.

On slide 11, this is really a very different item here on slide 11. Slide the 11 was the annual review, Eric, of all of our actuarial assumptions across our entire portfolio of products in all of our geographies.

As Simon pointed out a minute ago, there were a number of pluses and minuses in the quarter. For example, we strengthened our volatility reserve assumption for equity markets and so that was part of the reserve strengthening in that line item. We also lowered the reinvestment rate assumed in the valuation model. That was a reserve strengthening.

Going the other way was for long-term care. We did an update, really better modeling of how we actually manage the investment portfolio that supports long-term care. That indicated a reserve release.

So it's really the sum total of those items that led to the favorable reserve release that is outlined on slide 11.

Eric Berg - *Barclays Capital - Analyst*

Thank you. Very comprehensive. And thank you, Donald.

Operator

Doug Young, TD Newcrest.



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Amir Gorgi - Manulife Financial Corporation - VP, IR

Doug, are you there?

Donald Guloien - Manulife Financial Corporation - President & CEO

Operator, why don't we skip to the next one and try and go back.

Operator

Darko Mihelic, CIBC.

Darko Mihelic - CIBC World Markets - Analyst

Couple of questions. First, on slide seven the notable items that add up to about CAD975 million. If I am thinking about this correctly, do most of those go through assumption changes and the rest of them go through experience gains?

I don't need exact numbers. I just need to have a ballpark figure of how much is going through assumption changes and how much is going through experience gains?

Simon Curtis - Manulife Financial Corporation - EVP & Chief Actuary

It's Simon. The only one on that slide that goes through the assumption changes is the CAD783 million impact of the annual valuation basis change. Most of those other items would effectively go through the experience gains and losses in the source of earnings.

Darko Mihelic - CIBC World Markets - Analyst

Okay, thank you. That is helpful and then it leads me to the next question, which is as I am to understand it your view of normalized earnings include an earnings on surplus. And since none of these items actually affected earnings on surplus, could I look at the number that happened this quarter and think of that as basically part of an underpinning of that CAD750 million to CAD850 million of earnings?

Mike Bell - Manulife Financial Corporation - SVP & CFO

Darko, it's Mike. The short answer is, yes. Now, again, in fairness the interest on surplus in the quarter benefited from some realized capital gains that we had on the sale of equity. So that contributed to the CAD803 million.

Just in full disclosure, the CAD803 million though was depressed by the higher than expected levels or higher than normal levels of new business strain. But the short answer is IOS is a key component of what is in the adjusted earnings from operations.

Darko Mihelic - CIBC World Markets - Analyst

Would it also be fair to think of that CAD803 million though as also have been helped by some tax recoveries?



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Yes, that is fair.

Darko Mihelic - *CIBC World Markets - Analyst*

Okay. Another question then looking at slide, I think it's 21 here where we talk about capital.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

21, Darko.

Darko Mihelic - *CIBC World Markets - Analyst*

Yes. Sorry, 22; I apologize. The last bullet there, the CAD1 billion of contingent capital in the holdco, how are we to think of this if we go to a holdco MCCSR sort of approach with OSFI? Is that capital actually -- is that something you could actually downstream if we were to actually think about these things on a consolidated basis?

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Well, a couple things there. First, I think, Darko, it is way too early to speculate on what OSFI might be doing in the future around holdcos. I don't think I would try to speculate at this point.

I think what is most important about the CAD1 billion that we have today sloshing around the holdco is that it could be downstream today into MLI to strengthen the MCCSR. I think that is the most important point.

Now, again, also in full disclosure, we do expect to use that CAD1 billion in the future to repay our CAD1 billion outstanding on our bank loan. But it is fair to say that today it is a contingent source of capital if we were in a pinch.

Darko Mihelic - *CIBC World Markets - Analyst*

Okay. And thanks very much for that. Maybe just my last question and this relates to slides 23 and 24. You outlined the reorganization and you outlined the benefits. I guess the question that comes to mind is why wasn't this done before? There must have been a reason for not having it consolidated or reorg'd this way?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Well, this is an embarrassing one to answer. It took a huge amount of activity. I mean it's a massive -- you would not believe what an administrative undertaking it is. It's something we have been working on for a couple of years.

The second thing is we had to get regulatory approval, and you can imagine around year end last year regulators were sort of focusing on the highest priority items and they certainly didn't want to focus on this one. We need approval of Michigan, Massachusetts, and New York in order to effect this reorganization.

The good news is that the work has essentially been done. I am working looking at Jim Boyle here and the massive project is well on its way to completion. And it looks like we are getting regulatory approval. So we think this is a very positive move for our company.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Darko Mihelic - *CIBC World Markets - Analyst*

Thanks very much.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

By the way, it will reduce operating costs very significantly. The first of which is we won't have the cost of the project ongoing and the second is we won't be administering two different subs, essentially managing very similar business. So ongoing this will produce very significant expense benefits, which is not a trivial part of the equation.

Darko Mihelic - *CIBC World Markets - Analyst*

Okay, thanks very much.

Operator

Doug Young, TD Newcrest.

Doug Young - *TD Newcrest - Analyst*

Good afternoon. I will try this again. Hopefully, it will be quick.

The first question I guess for Michael or Simon. Are you done with the reserve basis changes? Meaning if everything stays unchanged from where we are today, are you comfortable at the end of Q4 that there isn't other things going to come out of the woodwork?

Simon Curtis - *Manulife Financial Corporation - EVP & Chief Actuary*

It's Simon here. We did a very thorough and complete review of the third quarter. It was our full annual review. We have booked all the reserve adjustments that were appropriate that went through our review process with internal auditors and peer reviewers.

So I am confident in saying that at the moment the balance sheet is totally up to date, and there is nothing that has been deferred to the fourth quarter.

Doug Young - *TD Newcrest - Analyst*

Second, just on the hedging for a seg of variable annuities, you did it for the business in Canada, for the in-force business in Canada, the 3.8. It doesn't look like you did any in-force in the US, and I am just curious as to why that was. Is it just because you weren't able to get that 50 basis point margin?

And I guess the second part of the question is, Don, when you look at this do you look at your gross value at risk? What is the optimal amount to have hedged eventually?

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Well, you answered your first question very well, so let me just confirm your answer. We look at all the inputs, the cost of swaps, the cost hedging, and so on, and where the market is and how much the net amount of risk is and look to make roughly 50 basis points from issue.

Obviously there is some judgment applied. We can press the accelerator a little heavily and do it at less than that. We can do it a little bit more than that. It depends on market conditions, but that is the general tenor of it.

We would like to get a substantial amount of this. I would love to see, say, 70% of it hedged. When you combine that with what we have reinsured that would be a very substantial decrease in the amount of sensitivity.

But, again, we have the shareholders interests at heart here and we are not going to rush into it and do it before it's most appropriate. That has served us well. It's not that we are being emboldened by the approach we have taken. That could be dangerous.

But we will watch the situation and if we perceive that there is a greater downside equity risk we will accelerate. Otherwise we will stay the course. We think it's a very good plan of action.

Doug Young - *TD Newcrest - Analyst*

Okay. Just lastly on the changes to assumptions in Q3, part of the investment return as you mentioned was long-term care and the URR. On the long-term care side I know you had a mismatch on that on the asset -- duration, asset liability match. Have you turned that out? Is that what you are referring to?

And on the URR side, can you give us an indication of where you stand relative to where the end of the year might come out in terms of the calculation? Thank you.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Yes, there is some degree of a mismatch. But that is more overwhelmed by the structural nature of the businesses where we simply do not know what we are going to invest future premiums at and there is no practical way of hedging out both the underlying treasury and the corporate A rate. So structurally you are going to be exposed on an interest rate basis to these large changes in interest rates that we are seeing today.

That is the biggest part of it. This isn't some sophisticated ALM call where we think we know better than the markets and are short. The products, the valuation ask the question what will that premium in the 16th year earn, what will the premium in the 19th year earn, what will it earn the 23rd year?

And the convention is to use today's spreads as if they persist for that whole period with a swap curve. The interest rates applied by the swap curve. Obviously, when you apply to those things in today's market you get very conservative results.

It's anybody's guess what we will actually obtain in the future. We will look at ways of desensitizing ourselves to those interest rate movements, but structurally it's part of the product.

I think long-term, frankly, companies that are exposed to this will move to build more adjustability into their products or charge more for taking the risk, because we have such large accounting volatility associated with that. But that is really what it is, accounting volatility more than an investment decision to mismatch.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Simon Curtis - *Manulife Financial Corporation - EVP & Chief Actuary*

I will just answer the second part of the question which is about the ultimate reinvestment rates. The long rates that we are using at the moment, the long bond rates, ultimate rates are 4% in Canada and 4.1% in US.

Those rates were set looking forward basically a year from today to what we think the ultimate rates would be under the [inaudible] standards if current market rates didn't change. So we sort of took a one-year look ahead and used that to set our ultimate reinvestment rate.

Doug Young - *TD Newcrest - Analyst*

Thank you.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

We have gone 20 odd minutes past our time. I hate to close off the call, but why don't we take one more question if that is all right.

Operator

Mario Mendonca, Genuity Capital Markets.

Mario Mendonca - *Genuity Capital - Analyst*

Good afternoon. Thank you for all the details you have provided. Much more than this company ever did when it first demutualized, but I certainly appreciate everything.

The question that trumps everything though, at least that I get, is there are investors that can understand Manulife will eventually emerge from this as a strong company with good earnings. The question is will they be diluted before then, an existing shareholder.

So going back to this whole MCCSR and maybe even the holding company and rules around the segregated funds, Don, can you help us understand what is this fortress capital? And you refer to 150% as this sort of minimum MCCSR, but I think we all appreciate that Manulife can't get anywhere near 150 without the stock price being much lower, the regulators and rating agencies losing it. So what is the real number for Manulife in terms of an MCCSR you could go to?

Maybe I will stop there and ask, help us understand what this fortress capital means and what the minimum really is?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Well, as Mike said before and I have said, fortress capital is the level of capital that would allow us to sustain the most draconian scenarios. But not all of them. There will always be scenarios you can construct that are worse. There is great deal of comfort that we wouldn't have to go to capital markets.

I think you used an expression there Mario describing regulators and rating agencies, I am not sure I would use the same expression, but it's clear that if the S&P were to go to, let's say, 650 in the next quarter the rating agencies, regulators would say



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

so what are you going to do about it. I don't think they would be so perverse to expect that it would be dealt with immediately, but they would sure want to see a plan for dealing with it.

So that is why we are opting on a lot of things on the conservative side without subjecting our shareholders to what I think is the ultimate indignity, which would be to hedge it all out at the bottom of the market.

Mario Mendonca - *Genuity Capital - Analyst*

Don, can I just interrupt for a second? If Manulife's MCCR were at 190 next quarter would that cause you to want to raise common equity or some kind of equity or some kind of capital to get it back up above 200?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Mario, my answer -- I can't speak for -- you asked the question in the context of regulators and rating agencies. My answer would be clearly, no. If the equity market moved down, I mean you could look. You could find days in March where our MCCR was a heck of a lot lower than it was today.

I would hope you wouldn't have a knee-jerk reaction to that. If you felt that it was going to go down and stay down, that is a different story.

Mario Mendonca - *Genuity Capital - Analyst*

But 190 is not your -- even 200 then is certainly not your threshold?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

No, as we said before we are trying to provide a comfortable cushion between where we are and the ultimate level of 150, which is the regulatory action level. I think you have captured it correctly though. I think, again, if markets fall people look to you.

The sort of standard is -- I think rating agencies and others are not looking through the cycle anymore. They are saying at your worst point do you have the capital of a double A or triple A company? So it's a tougher standard.

I have been very open with that saying regulators, rating agencies, and some equity investors and the general public expect companies to have very high levels of capital under the most odious circumstances. You just have to pick up the paper and you know that is a true statement. So that is why we are moving in the direction of fortress capital and took the actions we did on the dividend, however unpopular they were at the time and may continue to be.

Mario Mendonca - *Genuity Capital - Analyst*

And then, finally, on the segregated funds. OSFI has talked about holding company capital -- I think, Mike, you said way too early to ask about that. How about the notion that they are going to review all the internal models for segregated funds and they are going to comment on the next year?

Maybe for Mike or Simon, could they essentially -- I know this sounds strange, could they essentially reverse what they did in the fall of 2008 on seg funds?



Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Mike Bell - *Manulife Financial Corporation - SVP & CFO*

Mario, it's Mike. I just think it's not very productive exercise to speculate on how OSFI might think about this in the future. The bottom line is the seg fund product meets a societal goal here and that is to provide a floor on people's equity risks.

It also seems to me very unlikely, at least I would like to not -- I would like to believe that our regulator would be very thoughtful and would be unlikely to enact standards that would hurt the Canadian insurance industry or put us at a relative competitive disadvantage versus companies in the US or Europe. So, again, for those reasons I don't think it's very useful to try to speculate.

Mario Mendonca - *Genuity Capital - Analyst*

Why did they refer to it then in that speech? Why did they make a point of specifically saying the internal models were flawed?

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Well, they made some changes to the internal models, Mario, I think that is what it referenced to. And remember they made some changes. Now remember when they made the changes it was a complex series of changes. In some conditions it gave forbearance, in other conditions it actually got tighter.

They built-in essentially an anti-procyclical measure, which I think was actually quite clever and good, and that is that it gave some forbearance in down markets on the assumption that --

Mario Mendonca - *Genuity Capital - Analyst*

Don, I am referring to the speech that was made a couple of weeks ago.

Donald Guloien - *Manulife Financial Corporation - President & CEO*

Yes, yes. No, let me finish. It actually will tie into your question, believe it or not.

They gave some forbearance recognizing that the fundamental approach has some conservatism in it. When markets have gone down 50% to assume that they then go down model them at a very high CTE level that assumes they maybe go down another 30%, stay down for 10 years, and then very slowly recover after they have already come down a dramatic amount, is projecting an extremely draconian scenario.

So what they did is they gave a little bit of forbearance and said that may not be appropriate, especially if it's a long time, if there is a long time until the liabilities come due. But they didn't -- contrary to public opinion, they didn't give just one side in forbearance.

What they did is said when things improve we are going to put an averaging formula in that is going to grab some of that back. And guess what, that averaging formula is grabbing some back. I am not at liberty, I don't think, to talk about how much is being grabbed back at this time.

But if you made the assumption that the reserving standard is less conservative today than it was six months ago or a year ago, it may not be accurate, Mario.

Nov. 05. 2009 / 7:00PM, MFC - Q3 2009 Manulife Financial Corporation Earnings Conference Call

Simon Curtis - *Manulife Financial Corporation - EVP & Chief Actuary*

It's Simon here, Mario. I would just like to jump in. OSFI is consulting the industry on a number of things, learnings they have had from the last year. Now that the worst of it has hopefully passed OSFI is looking at all of the areas of provided stress points -- stress testing, holding company rules, fundamental MCCR rules, seg fund guarantees.

And I thinking it's dangerous just to pick out one area. The reality is OSFI is looking at a number of areas; they are trying to do this on a consultative basis. I think it would be wrong for us to say seg fund rules will never change. But I think anything that that will be introduced will be done in a very thoughtful way and it will have a lot of impact studies and discussion I think before OSFI is ready to implement any changes.

Mario Mendonca - *Genuity Capital - Analyst*

Sounds like some give and take. Thank you very much.

Operator

That concludes today's question-and-answer session. I would now like to turn the meeting over to Mr. Gorgi.

Amir Gorgi - *Manulife Financial Corporation - VP, IR*

Thank you, operator. And we will be available after the call for any further follow-up questions. With that I would say good afternoon.

Operator

Thank you. The conference has now ended. Please disconnect your lines at this time. Thank you for your participation.

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