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# MFC - Q2 2010 Manulife Financial Corporation Earnings Conference Call

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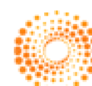

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## CORPORATE PARTICIPANTS

**Shad Ansari**
*Manulife Financial Corporation - Assistant Vice President, IR*

**Donald Guloien**
*Manulife Financial Corporation - President & Chief Executive Officer*

**Michael Bell**
*Manulife Financial Corporation - SEVP & Chief Financial Officer*

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

**Jim Boyle**
*Manulife Financial Corporation - SEVP & President of John Hancock Financial Services*

**Beverly Margolian**
*Manulife Financial Corporation - EVP, Chief Risk Officer*

## CONFERENCE CALL PARTICIPANTS

**Doug Young**
*TD Newcrest - Analyst*

**Michael Goldberg**
*Desjardins Securities - Analyst*

**Darko Mihelic**
*Cormark Securities - Analyst*

**Tom MacKinnon**
*BMO Capital Markets - Analyst*

**Mario Mendonca**
*Canaccord Genuity - Analyst*

**Andre-Philippe Hardy**
*RBC Capital Markets - Analyst*

**Steve Theriault**
*BofA Merrill Lynch - Analyst*

**John Aiken**
*Barclays Capital - Analyst*

**Colin Devine**
*Citi - Analyst*

**Robert Sedran**
*CIBC - Analyst*

## PRESENTATION

**Operator**

Please be advised that this conference call is being recorded. Good afternoon, and welcome to the Manulife Financial Q2 2010 financial results conference call for August 5, 2010. Your host for today will be Shad Ansari. Mr. Ansari, please go ahead.



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**Shad Ansari** - *Manulife Financial Corporation - Assistant Vice President, IR*

Thank you, and good afternoon. Welcome to Manulife's conference call to discuss our second quarter 2010 financial and operating results. Today's call will reference our earnings announcement, statistical package and webcast slides, which 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.

Today's speakers 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. For additional information about the 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.

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Thank you, Shad. And I like to say good afternoon, but it certainly doesn't feel like a good afternoon. Our second-quarter results announced this morning were extremely disappointing. I want to take a few minutes at the outset to address this, coming as it did after the much stronger results of the past two quarters. I also want to focus on our underlying business, which performed very well this quarter, and underscore our desire to reduce more of our equity and interest rate sensitivities, moving Manulife towards more consistent, growing earnings and ROE.

Our CFO, Mike Bell, will then address our results in more detail. We have most of the members of our senior management team on the call, including our general managers Bob Cook for Asia, Paul Rooney for Canada, Jim Boyle for the United States and Warren Thomson for Investments. We look forward to their taking your questions as well.

So first, let's put today's results into perspective. The main story this quarter was the impact of lower equity markets and historic low interest rates, which resulted on a Canadian GAAP basis, in large, non-cash charges in the form of mark-to-market increases to our reserves for policyholder liabilities.

Under our Canadian GAAP reporting, we took CAD1.7 billion in charges related to equity market declines and CAD1.5 billion related to interest rate declines. We would expect that most of these charges eventually reverse if the interest rates rise or returns on equity markets recover faster than the long-term growth rates used in the valuation of our policyholder liabilities.

Under Canadian GAAP, Manulife's earnings and balance sheet capitalizes the impact of today's low interest rates. Therefore, if rates stay the same, other than any new businesses strain, if any, there would be no further material negative impact on earnings. But if rates increase, earnings will increase.

We would also expect reserves to reverse if equity markets recover faster than the long-term growth rate used in the valuation of our policy liabilities. In fact, the turnaround in equity markets in July alone, if sustained, should reverse a substantial portion of these losses.



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Our interest-rate sensitivity is higher than other Canadian companies, primarily because we have more of this long-term guaranteed business. And our interest-rate sensitivity is higher than other US life-insurance companies, both because of the quantity of our business and the different accounting regimes.

As a point of comparison, under US GAAP, we would expect to report a small profit for the second quarter. It is a very substantial difference. It is also interesting to note that on a US GAAP basis, our US GAAP shareholders' equity would be about $7 billion higher than on a Canadian GAAP basis.

Our press release has provided more details on our equity and interest rate sensitivities, the effectiveness of our hedging activities in the quarter and the expected costs and potential fee revenue upsides of our hedging when markets once again rise, all items that will be of interest for analysts and investors.

There is, however, more to be done to get Manulife back onto a consistent track that shareholders expect and deserve. Our approach has been to hedge equity risk when it is of economic benefit to our shareholders -- that is, when the guaranteed value is close to the account value -- truly minimizing the impact to present and future earnings and capital.

As you know, in the spring of 2009, we had about 20% of our in-force variable annuity business reinsured. But the remainder of the block was almost totally unhedged. Now 51% is hedged or reinsured. Some would criticize us for moving too slowly on hedging the in-force. Others, in fact, worried that it was too fast. But we have stuck to a plan. We intend to have hedged or reinsured at least 70% of our business -- variable annuity guaranteed value -- by the end of 2012.

With the expected market volatility, we believe we have a very good chance of achieving this target. And if we are offered the opportunity, we will proceed to hedge even more of our VA-related equity risk.

Financial strength remains a positive differentiator for Manulife, and in that regard, I will comment briefly on an announcement from Standard & Poor's today. Our Standard & Poor's rating has most recently been higher than almost any other publicly-traded financial company globally. We've been very proud of that.

The one-notch change announced by Standard & Poor's today takes our key operating life insurance companies to a AA rating. This is still a higher rating than any of our public lifeco competitors in North America, with the exception of one company that shares the AA rating. Some mutual companies in the United States may have higher ratings, but in fact none of our public lifeco competitors globally has a higher rating from Standard & Poor's.

Our financial strength remains solid, with a strong capital base and a very strong set of investment management results.

I also want to emphasize that our sales and business performance remains strong. Over several quarters, we have been making progress on rebalancing our business mix, repricing and redesigning products -- some products to reduce risk. As I've said many times before, we are emphasizing margins over market share.

We are cutting back significantly on products that give rise to the interest and equity exposure or repricing could give us substantially more downside protection.

We are also dramatically accelerating the growth of other products. We are building positive sales momentum, particularly in Asia and Canada, and the retirement plan services and mutual fund businesses in the United States, none of which give rise to exceptional interest rate or equity sensitivity. This is a dramatic reformation for our Company.

This quarter, insurance sales were up 30% in Asia. Non-variable annuity wealth sales increased 38% in Asia as well. Mutual funds increased 50% in the United States, and 175% in Canada. New business embedded value increased 10% on insurance products and 6% in wealth products, excluding variable annuities and US book value fixed deferred annuities, sales of which we attempted to discontinue.



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We are successfully repositioning the business. Capital and credit both remain strong. We're deploying our capital to increase long-term shareholder value. And we are confident that demographic and other trends favour the long-term growth of our business.

As I said at our annual meeting in May, I believe that investors in companies such is ours should be able to expect an ROE of 14% over the long-term. That is not guidance. That is what I think a reasonable expectation of capital markets would be.

The ongoing volatility of the macro environment, coupled with our open-risk position, leaves us with considerable volatility until such time as we are able to hedge or otherwise mitigate more of the risks. We are taking difficult decisions over the course of this year to better position the Company for the future. I believe we are taking the right actions to improve earnings to highly satisfactory levels over the coming years, even assuming today's low interest rates and no more than normal equity market returns.

We expect to share more details on those plans to grow our business, to improve our earnings stability and increase our ROE, with investors in the fall. With that, let me turn it over to Michael Bell.

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Thank you, Donald. Hello, everybody. Today, we reported second-quarter shareholders' net loss of CAD2.4 billion, which equates to CAD1.36 a share on a fully-diluted basis. Our results in the second quarter were impacted as equity markets declined globally and interest rates decreased materially, particularly in the US.

While decreases in equity markets and interest rates are industry wide concerns, they are significantly more pronounced under Canadian GAAP than for US GAAP results due to the mark-to-market nature of the methodology.

On a US GAAP basis, we do expect to report positive net income for the second quarter when we release these results next week. In addition, our past efforts to strengthen our capital position served us well during this volatile quarter, as MLI's MCCSR stood at 221% on June 30.

Our fixed income portfolio also continued to perform well relative to overall market conditions, as net credit impairments and actuarial charges related to credit downgrades were only modestly higher than the long-term expected credit losses assumed in the valuation of policy liabilities.

Also in the second quarter of this year, as Donald mentioned, our underlying business mix shift continued to be favorable. So, two examples. First, on a constant currency basis, our Asian insurance sales grew by 30%. And secondly, excluding variable annuities and book value fixed deferred annuities, second-quarter wealth sales across the enterprise increased by 22% relative to the prior year. These are two good examples of where we are successfully growing our targeted, high-return businesses. And I'll provide some more detail in a few minutes.

On slide eight, we provide a summary breakdown of the notable items included in this quarter's and also last quarter's after-tax earnings on a CGAAP basis. As noted on the slide, the second quarter's unfavorable equity market performance had a negative impact of approximately CAD1.7 billion after-tax. In addition, interest rate declines had a negative impact of approximately CAD1.5 billion after-tax.

Now importantly, our balance sheet and capital position under Canadian GAAP already reflects most of the potential long-term impact of current interest rates on our in-force business. A small decline in the ultimate reinvestment rate or URR, is the main exception, which I will discuss in a few minutes.



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Now, as shown on the slide, we had favorable after-tax contributions from other net investment related items, net policyholder experience changes and actuarial assumptions, and for favorable tax items related to closed years.

The strengthening of the Canadian dollar relative to June 30 of 2009 reduced earnings by CAD48 million. As you will recall, the June 30, 2009 rates are used in our definition of adjusted earnings from operations.

Now, adjusting for these items, our adjusted earnings from operations for the first quarter totaled CAD658 million after-tax, which was below the range of our expectations, due primarily to higher new business strain caused by low interest rates and the lack of AFS gains during the quarter and our equity investments in the surplus segment.

We've implemented new business price increases in the US insurance businesses, and we expect new business strain to improve later this year. And as long as equity markets continue to improve, we expect to be positioned to generate some AFS gains in the last half of the year.

Slide nine details the impact of equity markets on our results in the second quarter. As noted, the S&P 500, TOPIX and S&P/TSX decreased during the quarter by 11.8%, 14.1% and 6.2%, respectively. We estimate that the negative equity market performance and VA hedging program results resulted in a net negative impact of approximately CAD1.7 billion.

Of the total charge, CAD1.3 billion related to the unhedged block of variable annuity business, and was calculated by comparing the impact of the actual returns during the quarter to the results we would have experienced if equity returns had been consistent with our long-term market growth assumption of approximately 2% per quarter.

Now with the strong equity market performance since June 30, some of this loss may reverse in the third quarter.

For the hedge block, the variable annuity CGAAP liabilities increased by approximately CAD1.6 billion pretax, while the pretax gains on the hedge instruments were CAD1.2 billion. The result was an after-tax impact of approximately CAD276 million, which included the impact of increases in the provisions for adverse deviations in our CGAAP reserves, which are not hedged.

In addition, higher realized volatility and some residual interest rate risk, which is not hedged, contributed to the overall hedging program result for the quarter.

In slide 10, we provided a summary of our equity risk exposure. Over the last 12 months, we've reduced this risk exposure by hedging substantially all of the new variable annuity sales and by increasing the amount of in-force business hedged. As of June 30, 51% of the guaranteed value business was reinsured or hedged, and that was the same percentage as March 31.

While our progress will depend on market conditions, we intend to have hedged or reinsured 70% of our in-force variable annuities by the end of 2012.

Turning to slide 11, under Canadian GAAP, changes in interest rates impact the actuarial valuation of in-force policies by changing the future returns assumed on the investment of net future cash flows. During the quarter, both Treasury and corporate bond rates declined to levels that are historically low. And the impact of the decline on our second-quarter CGAAP results was nearly CAD1.5 billion after-tax.

The largest decline was in the US, which is the geography which drives the majority of our sensitivity. 10-year and 30-year Treasury rates declined by approximately 90 and 82 basis points respectively, and published benchmarks for A-rated US corporate bonds declined by 63 and 54 basis points for the same period.

Now, while spreads between Treasuries and A-rated US corporate bonds widened, this had a limited impact on our second-quarter earnings. This was attributable to how we determine our interest rates used for our policy valuation, which is based on a number of factors, including our Company-specific projected investable universe, our ultimate reinvestment rate, based upon government



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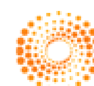

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bonds after 20 years, and the fact that we limit the impact of spreads in excess of long-term historical averages, based upon emerging best actuarial practices.

That last item had an impact of approximately CAD380 million after-tax in the quarter, and we expect the basis change in third quarter of 2010 to begin a process of grading current spreads to long-term averages. As a result of limiting the impact of spread widening in the second quarter, we do not expect the basis change in this area to be material to earnings in the third quarter. Again, all of these impacts are based on Canadian GAAP.

In contrast, importantly, our reserve assumptions continue to be sufficient on a US GAAP basis, despite the current interest rate environment.

Now, turning to slide 12, our fixed income portfolio continued to perform very well relative to the overall market conditions, with net credit impairments of CAD35 million, while actuarial charges related to credit downgrades were CAD2 million. And these amounts were only slightly higher than the CAD27 million of expected credit losses assumed in the valuation of policy liabilities. So overall, we continue to be pleased with our credit results.

Moving to slide 13, we've provided a summary of our results by division, excluding market and investment related experience. The divisional results shown here include policyholder gains and losses, but not market and investment results. And as noted, on a year-to-date basis versus the prior year, Asia, including Japan, has experienced significant earnings growth of 34% attributable to profitable growth in key target markets.

This result is followed by a strong result in Canada, which has experienced 8% earnings growth, while the US has experienced a decline. In Canada, higher assets under management and bank volumes were offset by higher new business strain on life insurance and mutual funds.

The decline in results for the US business reflects higher new business strain on insurance sales, the experienced losses in long-term care and higher in-force hedging costs, which much more than offset attractive growth in our retirement and mutual fund businesses.

Turning to our source of earnings on slide 14, expected profit on in-force was CAD801 million in the second quarter, down by 8% compared to the prior year. But as you can see in the pro forma table in the footnote, excluding the impact of currency, expected profit on in-force was up approximately 7%, despite the earnings headwind from hedging more in-force variable annuity business in the last 12 months.

The impact of new business strain of CAD158 million was more pronounced than the prior year, primarily as a result of lower interest rates. And while we increased new business prices earlier in the year on our US insurance products, we do not expect to begin to see the favorable impact of these price increases until next quarter.

The net experience loss of CAD4.2 billion primarily reflects the decline in equity markets and decline in interest rates, and earnings on surplus funds were CAD61 million, constrained by the absence of equity AFS gains and lower investment income from lower investment yields.

Our effective income tax rate was more normal this quarter versus the prior year, as the prior year rate had benefited from gains in lower tax jurisdictions and losses in the US.

Slide 15 summarizes our regulatory capital position for MLI. Our balance sheet and capital position remain strong, although lower than March 31, due primarily to the second-quarter loss. And the actions that we took over the last two years to strengthen our capital and to reduce our equity exposure had increased our ability to weather this quarter's turbulence.



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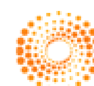

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Slide 16 provides an updated estimate of earnings and capital sensitivities for equity markets and interest rates. As we've discussed before, these are high-level directional estimates based upon changes to a single factor. And while we disclose these sensitivities to provide some general direction, in reality, several factors change in the same quarter, and no simple formula can model the earnings impact in any given quarter with precision.

Now with that point in mind, from a consolidated earnings perspective, we estimate that a one-time immediate equity market decline of 10%, followed by normal market growth at assumed levels, would now reduce reported earnings by approximately CAD1.3 billion after-tax.

The increase in sensitivity versus the prior quarter is largely due to the higher in-the-moneyness of these exposures.

As a result of the decrease in interest rates, our sensitivity to 100 basis point parallel decline in interest rates has increased to CAD2.7 billion as of June 30.

I will now turn to our top-line results, beginning on slide 17. Total insurance sales in the second quarter grew by 9% over the prior year on a constant currency basis. And we achieved an increase of 30% in the Asian insurance sales, which is an important priority for us as we seek to rebalance our portfolio by growing our highest-return businesses. And the next several slides detail those insurance sales by division.

So let's turn to Asia on slide 18. Second-quarter insurance sales in Asia grew by 30% over the prior year on a constant currency basis, and we achieved strong sales growth in most of the countries in which we operate.

In Japan, the second quarter represented a record quarter for sales, as continued growth of the MGA channel resulted in a 41% increase versus 2009. Continued agency channel expansion during the quarter helped to fuel a 36% increase in Hong Kong insurance sales. And in China, Manulife-Sinochem received new licenses to operate in two additional cities, and we are now licensed in 43 cities across 11 provinces.

On slide 19, while aggregate insurance sales in Canada decreased by 12% relative to the prior year, importantly, strong momentum continued in individual insurance and affinity sales, which were up 12% over the prior year. And this was driven by strong sales in permanent insurance products and a return of the larger size policies, which may signal increasing consumer confidence in the economy. So to be clear, we continue to feel good about our Canadian insurance sales.

Slide 20 shows the US insurance sales were up 4% over the prior year on a US dollar basis. John Hancock Life increased prices over the last year, which improved margins and also reduced market share. While these actions were important steps, they contributed to a decline in sales of 9% to the prior year.

While long-term-care sales grew in the second quarter, they are expected to slow during the second half of the year as a result of previously announced price increases and product repositioning to improve margins.

Turning to slide 21, our plans include growth for all non-guaranteed wealth products across all geographies. Excluding variable annuities and the US book value deferred fixed annuity products, total wealth sales were CAD6.5 billion, an increase of 22% on a constant currency basis over the second quarter of 2009. And we are very pleased with this growth.

On slide 22 in Asia, overall second-quarter wealth sales, excluding variable annuities, increased 38% over the prior year on a constant currency basis. Hong Kong sales increased by 19%, driven by increases in pension sales. Other Asian sales were up 35% over the prior year on a constant currency basis, and included the first full quarter of contribution from our 49% stake in Manulife TEDA. In addition, sales grew in Japan and Indonesia. And our new wealth management products generated good sales in Taiwan, which offset lower money market sales.



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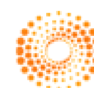

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On slide 23, in Canada, second-quarter Individual Wealth Management sales, excluding variable annuities, were CAD1.6 billion, up 7% from the prior year. Mutual fund deposits were almost triple the levels of a year ago. And as expected, sales of Fixed Products were down, decreasing 37% from a year ago. And this shift in product mix reflects improved consumer confidence in investment markets as well as early successes from our focused strategy to grow our mutual fund franchise.

Manulife Bank loan volumes exceeded CAD1.1 billion in the quarter, rebounding 25% from the first quarter and were 6% above a year ago. And the increase primarily reflects stronger execution in several key areas, including our latest consumer advertising campaign.

And Group Retirement sales in Canada were solid in the second quarter at CAD175 million.

Turning to the US on slide 24, excluding variable annuities and book value fixed deferred annuities, second-quarter wealth sales increased 34% over the prior year. John Hancock mutual funds experienced a 51% increase in sales, attributable to improved market conditions relatives to last year and a broad offering of competitive funds. At June 30, John Hancock funds offered 18 four- or five-star Morningstar rated mutual funds.

Retirement Plan Services experienced record sales for the quarter, and increased by 24% over 2009 on the strength of distributional relationships, the acquisition of larger cases, as well as an improvement in market conditions. So to be clear, we are very pleased with the business mix change that is occurring in the US.

Turning to slide 25, second-quarter variable annuity sales decreased by 49% versus the prior year on a constant currency basis, which is in line with our ongoing initiative to better balance our risk profile across the geographies. Book value fixed deferred annuity sales declined, as the product was replaced with market value fixed deferred annuities, which have a better risk profile and are less capital intensive.

So overall, we are pleased with our growth in our highest return areas, like Asia, Canada, and the non-VA wealth businesses, including the retirement and mutual fund businesses in the US.

Turning to slide 26, premiums and deposits for the insurance businesses amounted to CAD5.3 billion for the second quarter of 2010, representing an increase of 3% over the prior year on a constant currency basis, reflecting growth of the in-force business. Premiums and deposits for the wealth businesses, excluding variable annuities and book value fixed deferred annuities, amounted to CAD9.3 billion for the quarter, representing an increase of 7% on a constant currency basis. We are pleased with our growth in mutual funds and retirement savings in both the US and Canada.

On slide 27, new business embedded value for the insurance businesses increased by 10% in the second quarter of 2010 relative to the prior year, driven primarily by an increase in sales and actions to improve the product margins.

New business embedded value on wealth products, excluding variable annuities and the US book value fixed deferred annuity, increased 6% over the second quarter of 2009. And new business embedded value for the variable annuity business decreased relative to the second quarter of 2009, in line with the sales decline and lower long-term interest rates, as we hedged the new business.

Slide 28 notes that total funds under management as of June 30 were CAD454 billion, representing an increase of over CAD7 billion over last quarter.

Now let's turn to our investment portfolio, as summarized on slide 29. Our holdings continue to be high-quality (technical difficulty). 95% of our bonds are investment-grade and our invested assets are highly diversified by geography and sector, with limited exposure to the high-risk areas noted on the slide.



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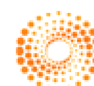

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We've also provided on slide 30 a detailed update on gross unrealized losses on fixed-income securities. We also show the progression over the last four quarters, which illustrates continued significant improvement.

Gross unrealized losses declined to CAD1.4 billion, representing a 20% sequential decline from the prior quarter and a decline of 72% year-over-year. At quarter-end, gross unrealized losses represented a relatively modest 1.2% of our total fixed income portfolio. In addition, unrealized losses for our fixed income portfolio, trading at less than 80% of costs for over six months, declined by 11% in the quarter to approximately CAD700 million.

Before I provide a summary, I would like to answer several questions that I believe are on some investors' minds. And the first is equity market sensitivity. Importantly, we have 51% of the variable annuity notional guaranteed value hedged or reinsured at the end of the second quarter. Because our earnings sensitivity is not linear, it has not reduced our sensitivity by 51%.

We have tended in the last two years to hedge new business and in-force blocks that are close to at-the-money. And as a general rule, the unhedged block tends to be deeper in the money and has proportionally more equity sensitivity, both upside and downside. So by design, we've strengthened our capital position, intending to avoid hedging under poor market conditions, and hence, we have a strong 221% capital ratio, even at the end of a very challenging second-quarter environment.

Going forward, we intend to achieve a position of 70% of the guaranteed value hedged or reinsured, and estimate that this could further reduce our equity sensitivity by approximately 15% relative to June 30, depending upon a number of factors, including assumed hedge effectiveness.

We also evaluate options to hedge more than the 70% target.

The second area I would like to comment on is around interest-rate sensitivity. As interest rates have dropped, our sensitivity to further declines has increased, due to the convexity of our long-duration liabilities under CGAAP standards. In addition, the growth in our reserves this quarter also increased our overall interest-rate sensitivity.

Regarding additional actions that we are taking, we have increased new business prices in the US for both life insurance and long-term care, our two most interest-sensitive businesses. And we expect these price increases to have a positive impact on second-half new business strain, as the new rates are sold and with some impact of lower volumes.

We've also introduced additional Universal life product designs to reduce the duration of the secondary guarantees. And we also intend to further evaluate interest rate hedging options, with a particular focus on options to hedge blocks of new business. And we will provide more details of our efforts in this regard in future calls.

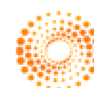
The third question relates to the third-quarter basis changes. Now to be very clear, this work is not yet complete, so we cannot give an expected range at this point. But let me discuss the three areas which we expect may be material.

The first is long-term care. We have not finished the morbidity study, but we know that morbidity has been unfavorable, particularly for the business sold many years ago, where plan designs tended to be richer and underwriting less stringent. We still need to complete our analysis of how we expect this to project out in future years. And after we complete the morbidity study, we expect to develop a state-by-state in-force rate increase plan and then file for these rate increases.

We will then make judgments about the net impact of the increase in projected future morbidity, minus the projected value of the in-force rate increases. And this net impact will be the net pretax amount of the basis change.

We will then estimate the tax effect of the charge and the net after-tax amount could exceed one quarter's amount of adjusted earnings from operations. And that is what we currently know, and we expect to have this completed by third quarter.





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Another basis change that is expected to be material is the updated URR, or ultimate reinvestment rate. We expect the reserve assumption for long-term government bond rates to decline by approximately 20 basis points. So in Canada, that would take it from 4% to 3.8%, and in the US from 4.2% to 4%. And we would estimate this would have an impact of approximately CAD300 million after-tax.

We've not completed this, so we will give any updates at third quarter when we finalize it. But that is the current estimate.

The third area is an update to our volatility assumptions used in the stochastic variable annuity reserve modeling calculation. Now in terms of very, very preliminary estimates, we estimate that this could be somewhat greater than the URR impact that I just mentioned. But we will provide more details on all of the basis changes as part of our third-quarter call.

The next overall question I would like to address relates to our capital position and any future capital plans at the present time. At a 221% MCCSR in MLI, we have a strong capital position. At that level, we would not intend to issue additional common equity or reduce the shareholder dividend under the current circumstances.

As you would imagine, we constantly work on a range of contingency plans to be able to deal with unfavorable events. We can never say never, but there are many other contingency plans that we would intend to pursue before we would resort to additional near-term actions with a dividend cut or a common equity raise.

The last question I would like to discuss is the guaranteed universal life lapse assumptions. In the recent past, concerns have been raised regarding our potential exposure to losses on our guaranteed universal life business in the US due to lower lapse rates than expected. In the second quarter of 2010, I would note that our guaranteed UL business actually experienced a lapse gain for the later durations, meaning those three years and beyond. And as we've emphasized, we've been proactive in addressing this risk in pricing and reserving, and we believe are assumptions are prudent. Our reserve assumptions generally assume less than 1% lapses after 10 years and grade to ultimate assumptions of one half of one percent or less.

So overall, our second-quarter 2010 results were greatly impacted by the mark-to-market impact of sharp declines experienced in global equity markets and further declines in the already low interest rates. The accounting implications of these items, particularly the Canadian accounting requirements related to interest-rate movements, resulted in significant mark-to-market charges to our income.

We are taking important actions to address the impact of economic conditions on our future results through additional pricing actions, changes to product design and shifting our business mix, by driving increased sales in high-return markets. And on these fronts, we made good progress during the quarter.

We also ended the quarter with a strong capital position and we experienced good credit performance relative to the overall market conditions. So our underlying business operations are well-positioned for future growth, as we continue to execute on our business plan.

With that, I will turn it back to Donald.

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Thank you, Mike. Let me just sum up with a few points. Q2 earnings were extremely disappointing, but were largely a reflection of Canadian GAAP mark-to-market accounting. We expect most of these charges to eventually reverse into earnings if interest rates rise and returns on equity markets recover faster than long-term growth rates used in the valuation of our policy liabilities, which is 2% a quarter plus dividends.



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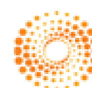

As I said before, July was a very positive month for equity markets. I think the US market is up 9%. We are addressing issues and reducing more of our earnings sensitivity. Our intention is to have hedged or reinsured at least 70% of our variable annuity fund guaranteed values over the next few years.

We have capitalized the impacts of lower interest rates on our in-force business, and new products are being designed with less interest-rate sensitivity than those of the past.

We have strong capital and credit results. We are rebalancing our business and redeploying our capital to increase long-term shareholder value. Our underlying business continues to perform well this quarter. We're successfully repositioning the business.

We are excited by growth opportunities, especially in Asia and in Canada, and we believe that demographic and other trends favor the growth of our business.

Finally, I believe we are taking the right actions today to improve earnings to highly satisfactory levels over the coming years, even assuming today's low interest rates and no more than normal equity market returns.

With that, operator, we are happy to open up to questions.

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## QUESTIONS AND ANSWERS

**Operator**

(Operator Instructions) Doug Young, TD Newcrest.

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**Doug Young** - *TD Newcrest - Analyst*

I guess the first question, Michael, you talked about on the capital position side, the MCCSR -- I guess first question is I understand the last time you did an equity issue, around 241 was the MCCSR. That was considered the fortress level. You're obviously below that. And you think there are other contingency plans that you would have before you would have to go raise equity or cut the dividend. Can you share with us what those contingency plans might be?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

I'll start. First, you're absolutely right, that the 221%, while it is lower than where we were after the equity raise, we do consider ourselves well-capitalized, and we don't feel compelled to take additional action.

But in terms of the kinds of contingency plans, there really are a wide variety of them. As an example, we could look to issue additional hybrids, which would add to our capital position, for example, perpetual prefs. We could look to different -- reinsuring different blocks to reduce the required capital. We could look at further constraining the products which drive the highest new business strains.

So again, there are any number of contingencies that we would look at in a turbulent environment. And again, that is something that we will obviously give updates, as appropriate, in the future.

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**Doug Young** - *TD Newcrest - Analyst*

And Don, am I correct to assume that you are below what you would have considered before fortress levels of capital?



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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

No, we have more of the risk off the table now -- obviously not enough, but more of the risk off the table. I am very comfortable with our capital position. I think I said in previous calls I am not going to keep commenting on whether we are semi-fortress, strong fortress or whatever. I think we have more than adequate capital levels, but obviously not as high as they were at the end of the fourth quarter of last year. But equity markets are moving around, and who knows what it will be at the end of this quarter.

**Doug Young** - *TD Newcrest - Analyst*

And then just -- I guess on the second question, on the Q3 basis changes, if I do the math and I listen to your comments, it sounds like the long-term care charge could be anywhere from CAD700 million to CAD800 million, the URR could be upwards of CAD300 million, and then the additional volatility assumptions around the VA could be another CAD300 million to CAD400 million. Am I doing the math correctly, and I guess when I think of that and I think of, again, the impact on your capital, should I be -- should we be concerned?

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Doug, first of all, it's important to note we are not done yet. So what I gave you were some high-level estimates based on the work that we've done to date. It is very important that we complete all of the work. I mean, we've got other items which at this point look like they would be smaller than what I described, but I wasn't trying to give you an exhaustive list. It was simply those were the three that are on my radar screen that I would expect to be material. So I wouldn't read too much into those estimates at this point. We will have more information when we get to next quarter.

As it relates to your other question, obviously, we will look at our capital position at third quarter. We will look carefully at some of the contingency plans that I've outlined, and we would look at other contingency plans over time.

At this point, though, I don't think it makes sense to panic. Again, thankfully, we had strengthened our capital significantly over the last year and a half, and it gives us the kind of resource and the kind of capital position to weather turbulence like what we had in second quarter.

**Doug Young** - *TD Newcrest - Analyst*

Just quickly, Michael, my math was right. Is that correct?

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

I don't think your math is unreasonable. I would just emphasize that those estimates are very, very preliminary. And actually, the only thing you said that I would actually correct is what we said was that it may exceed one quarter's worth of adjusted earnings from operations. I wasn't trying to tell you it is in the range of CAD700 million to CAD800 million. I was trying to tell you that it may exceed one quarter's worth of adjusted earnings from ops.

**Doug Young** - *TD Newcrest - Analyst*

Okay, just one last quick one. Don, with contingency plans also would you consider selling businesses?



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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Yes, I would, Doug. One of the things that occurred to us, quite frankly, is when you're looking at -- Manulife holds a something on the order of CAD30 billion in pfads (provision for adverse deviations) as part of our reserves. The Canadian accounting regime, though, is a very conservative one. And when you see these big differences between the US regime and the Canadian regime, you know, a lot of opportunities come to mind.

So these are things we have to look at. Again, I don't think we are, as Mike said, pressing the panic button at all. We raised additional equity for a whole bunch of reasons, as you know -- acquisitions and defensive moves. As we described at the time, it was initially going to be quite defensive and a little bit employed in acquisitions.

This quarter, it looks more defensive. But let me remind you that we had a quarter a year ago where we made CAD1.8 billion. We had another quarter where we made CAD1.1 billion earlier this year. Things can change.

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**Doug Young** - *TD Newcrest - Analyst*

Thank you.

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**Operator**

Michael Goldberg, Desjardins Securities.

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**Michael Goldberg** - *Desjardins Securities - Analyst*

Thanks. You provided a good road map for understanding equity market sensitivity, but less good for understanding your interest-rate sensitivity. What can you do to improve that road map? Or can you do anything?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

In terms of improving the road map, I think what is most important here is that we continue to increase new business prices to keep up with the decline in interest rates for our long-duration products in particular. So keeping our pricing as up-to-date as possible is really the most important.

Second would be to continue to look at different product designs, as I mentioned in the prepared remarks. We are certainly looking at, as an example, different universal life plan designs, in the US in particular, and we think that will help.

And then ultimately, we do need to look at how much of this new business should we continue to write, and also to look at hedging options. So those are really the most important business actions.

As it relates to the impact on earnings in any given quarter, there is no single formula that I can give you to make the arithmetic precise and predictable, based upon published measures. I understand that you are hungry for it. And we've given you the fact that 100 basis points now would be worth CAD2.7 billion after-tax. Again, it does -- that is not precise because that assumes a parallel shift in the interest rate curve, and it is never going to be precisely parallel.

But by looking in particular at Treasuries and to a lesser extent corporate bond yields, and the fact that we will be grading now the spreads to -- after the basis change -- to long-term averages, I think you will be able to hopefully better estimate it than the prior quarter.

Let me see if Simon wants to add here.



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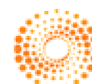

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**Simon Curtis** - *Manulife Financial Corporation - EVP, Chief Actuary*

I think the only thing I would add is that one thing I think people need to remember is our exposure is quite heavily weighted to the US market as well. And while you can't -- that can vary from quarter to quarter. At the moment, approximately 70% of our exposure looks like it is in the US. And if you're looking at one leading indicator, it would probably be government interest rates in the US and long government interest rates in the US.

**Michael Goldberg** - *Desjardins Securities - Analyst*

Okay. And I am also wondering have you done any what-if modeling of the impact on your MCCSR of indicated IFRS Phase II? And is it fair to say that the conclusion would be that because of the intense volatility created, the numbers would become almost meaningless?

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

I'll start and see if Donald wants to add. First, I think it is really too early to be too definitive in terms of where IFRS will come out. We are obviously reviewing the exposure draft. Exactly how liquidity premium, for example, will be defined and calculated is an open question.

But I think you raise a very important point, and that is there are serious potentially unintentional consequences that could come out of IFRS if in fact the final IFRS rules are what you are suggesting. And in particular, by ignoring the business model and separately looking at valuing assets separately from valuing liabilities and ignoring the connection between the two, that could, as you indicate, introduce even more volatility than we have under Canadian GAAP.

And I think your point is a good one, that it would make the financial statements probably even less relevant to investors.

So it is something that we are concerned about. It is something we are certainly talking to the various accounting and regulatory bodies about as well.

**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Well, you can see in this quarter, more than just about any other, the need to develop more harmonized standards around the world. We are great proponents of that. If you look on a US GAAP basis, they basically lock in a model office using long-term interest-rate assumptions. And until such time as the product lines actually go into loss recognition status, they hold on to those assumptions as if they prevail today.

You've got the Canadian GAAP basis that, because interest rates have dropped in the short term, having to do with central banks flooding the money supply to get the economy kick-started again, which would, of course, long-term drive up rates, but because the short-term rates are down, those get reflected in our valuation of policy liabilities as if they were going to occur for the foreseeable future.

So, very sensitive to interest rates and I guess sending a signal to companies that if you price high interest rates and you don't get them, it might be painful.

And then on the other hand, you would have IFRS that would use interest rates to value the liabilities under some versions. Now, this draft is asking a lot of open-ended questions, and we think that that is a very good sign. But you know, some versions of it would lock in a set of rates that bear no relation to what companies actually invest in at all. So, it would be an extreme disassociation.



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I think it makes no sense to have radically different regimes operating in different jurisdictions and telling investors totally different signals about the profitability of the underlying business. And we are very sympathetic with investors in wanting a more harmonized standard.

Having said that, we think some of the proposals that are around having to do with phase two of IFRS are patently ridiculous.

It also raises the question, which we are very concerned about frankly here in Canada, about Canadian companies operating in the United States and operating at a competitive disadvantage relative to those on US GAAP. Whether we think it is a sensible accounting standard or not, the fact of the matter is it could put us at a disadvantage.

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**Michael Goldberg** - *Desjardins Securities - Analyst*

Finally, what is your sense of the likely receptivity of state insurance commissions for applications for rate increases, and how long would you feel that that would take to be implemented?

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

You can turn that to Jim Boyle.

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**Jim Boyle** - *Manulife Financial Corporation - SEVP & President of John Hancock Financial Services*

Michael, thanks. I think if you recall, we did an in-force rate increase about two years ago. We had good state approvals there. We sit here today with virtually all of those states with the exception of two approved. There is a pretty straightforward actuarial requirement to prove your experience.

So we are confident that we will be within the bounds of the actuarial standards, and it is always a difficult endeavor to raise prices, particularly to products that are sold to the folks that are elderly. But the reality is the actuarial science does, in fact, support it. And I think what you will also find is that we will give clients options where they can reduce their benefits and get essentially no price increase. So it is very hard to handicap, but our past results have been pretty good.

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**Michael Goldberg** - *Desjardins Securities - Analyst*

Thank you.

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**Operator**

Darko Mihelic, Cormark Securities.

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**Darko Mihelic** - *Cormark Securities - Analyst*

Just a couple of quick numbers questions and then maybe a different question for Don. But first, Michael, in your press release you mention a deferred tax asset that was set up in the US. Can you tell us the size of that asset?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Yes, Darko, it is approximately $700 million in the US.



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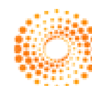

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**Darko Mihelic** - *Cormark Securities - Analyst*

Can you maybe gauge for us the risk that it has to be written down?

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Darko, we do not believe that there is an issue with recoverability based on the results to date. The real issue is around after the basis change in third quarter if there is a recoverability issue at that point. And it is just too early. We need to do that analysis, and, importantly, we need to finish the basis changes as well.

**Darko Mihelic** - *Cormark Securities - Analyst*

Thank you, and a second question also probably for you, Michael. I'm surprised you haven't thought about the goodwill charge that is necessary or likely. Can you give us any colour on that?

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Sure, Darko, trust me, we've thought about it. And it is something that, in all seriousness, we are reviewing as part of our normal financial processes, and particularly in light of the coming implementation here of IFRS Phase I. So I would expect to probably have a preliminary estimate for you at Q3.

Importantly, it would not have an impact on our capital, since in fact we don't get credit for goodwill today. But to date, we really view it as the rules are not really black and white in terms of IFRS versus what the rules have been under traditional CGAAP. I did note that Sun Life had estimated something like a CAD1.7 billion hit. I wouldn't be surprised if we were in -- something within that ballpark. Don't read too much precision into that estimate.

But I would expect we will have more information in Q3, but I don't expect to have any impact at all on capital. It would simply be a GAAP issue, and whether it is a net income issue this year or whether it is opening balance sheet issue with IFRS, my guess is it would probably be the latter, but that is all something we need to work through.

**Darko Mihelic** - *Cormark Securities - Analyst*

A couple more numbers questions real quickly, and I'll promise to requeue. Michael, you sounded confident that there is going to be some AFS gains in the second half. What is it that makes you confident that effectively your earnings from surplus or earnings from capital could be higher in the back half of the year?

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

A couple things. First, obviously equity markets have rallied since June 30. So we have more unrealized gains out there today on a pretax basis -- well over CAD100 million of gross unrealized gains out there in the portfolio. Where the equity markets go from here to the end of the year and how much of that we choose to trigger by realizing the capital gains will be a judgment and something still TBD.

But my point is I don't expect it to be zero, and it was zero in second quarter. So that was really the reference I was making.



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**Darko Mihelic** - *Cormark Securities - Analyst*

Okay, that's fair. And last question I promise. Don, you mentioned there would be a substantial recoup here if the quarter were to end today. Do you mind putting a number to that?

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

No, but I think you can just take the interest sensitivities and apply them whatever markets are up -- 9% in the United States -- equity markets, and 5% of the TSX. And I can't remember -- I think Tokyo is more or less flat. You can get a feel for it. But obviously, that is subject to day-to-day change.

I guess to go back on that question, the other thing is I guess as I make the observation, this is not a promise, this is not guidance. This is -- we used to generate investment gains on a regular basis in the past, and I think most of you guys remember -- I used to say, well, these aren't necessarily going to continue in the future and kind of warn people about that.

As we drive down some of these assumptions that are used to value our policy liabilities, as a result of the formulaic approach that is used, lower interest rates, I have got to believe there is an increased probability of outperforming those assumptions in the future. Now, I'm setting Warren Thomson up for a tougher standard, but he agrees with me on that.

It is not -- we don't have much choice in this thing, the way the interest-rate adjustment works. But the fact of the matter is as the base assumptions get more conservative, there is a greater likelihood of outperforming them, if in fact markets do recover and provide opportunities for investing at higher than those rates. That is not a guidance. That is not a promise. That is just a business person's outlook.

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**Darko Mihelic** - *Cormark Securities - Analyst*

Okay. Thanks very much.

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**Operator**

Tom MacKinnon, BMO Capital Markets.

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**Tom MacKinnon** - *BMO Capital Markets - Analyst*

Don, this question is for you. You say Manulife has taken the right actions to improve earnings to highly satisfactory levels over the coming years. So I think everyone wants to know here -- and it sounds like the actions are all the re-balancing, repositioning, repricing, getting away from any kind of interest guarantee business, seems to be a focus on more of the Asian instead of the US.

Now -- but what are highly satisfactory -- what is a highly satisfactory level of earnings, and how many years is it going to take to get there?

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

I guess what we are doing is we are slowing down some of our largest businesses, the areas of highest growth. Manulife grew very rapidly, taking the variable annuity risk and taking some of these long-term guaranteed product risks. We are slowing down some of our biggest businesses. We are putting the jets to businesses that are less large. Asia is not exactly tiny. It's huge. But other businesses that are smaller than that.



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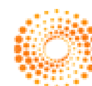

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And a lot of investors have asked us when will the positive news overtake the negative drag from shutting down some of the big businesses or reducing risks, selling less, all those things. And we're in the process of trying to figure that out. The direction is clear, but -- there is a lot of momentum. I'd like to say it would happen faster, but have to be honest with investors, that we get renewal premiums. So if we have a product that was priced in a way that we don't necessarily like today because it stays low interest rates, whether we like it or not, the renewal premiums keep coming in, keep coming in, and have to be invested at today's low interest rates. And that is what is reflected in the valuation.

So we are in the process of assessing that and how quickly we can grow in the business that we want to grow, and the impact of repricing actions, de-risking actions and other things on the business that have been a very substantial part of our history.

It is a dramatic reformation, but I can tell you I'm getting increasingly confident that we are getting the results. That is why I stress so much the underlying business results -- that we are getting the results that we want to have in the underlying businesses and that we will reach the crossover point.

I am not going to speculate on an ROE number. I mean, we go at it -- everybody knows that I think that investors deserve a 14% return. That's not a promise, but we use that as a benchmark when we make pricing decisions, determine what is a reasonable return and a good use of capital. So you can expect that we would trend up towards that level.

I have to be cautious because I don't have total confidence in the E of the ROE calculation. Regulatory capital requirements and so on could change. And I certainly am not the type of person that would applaud the management team if we got ROE up as a result of, for instance, writing off goodwill. That is a cheap way of getting to a result and not something that we would factor in.

I think of dollar earnings levels as a good measure of it, and I guess I have a target in mind that I'm sure wouldn't be altogether different than yours as what highly satisfactory is. But we need to do our numbers, get them a little bit more refined, have discussions with our Board, really test these things, because again, the last thing I'd want to do is show you some hockey stick that the management team doesn't buy into and we don't have a lot of confidence in.

I also would like to tell you that when we get those numbers baked down, I intend to hold people accountable for delivering in terms of their compensation plans, very directly on delivering those results. So we will hold people's feet to the fire in delivering them.

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**Tom MacKinnon** - *BMO Capital Markets - Analyst*

Let's assume that -- you talk about years to get there. Let's assume that it is by 2013 or '14, and then we are into IFRS Phase II and we are in a whole different paradigm here.

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Tom, let me reassure you, I don't think it is a good business plan that has a four-year hockey stick. I mean I've been around the pasture long enough to know that if it's so far out before the good news happens, it's probably not going to happen. And I would expect to see year-to-year increase.

Now, let's be clear what the year-to-year increase is. It has to be a neutralized for the impact of equity markets. If equity markets are up 15% next year, I'm not going to tell you we've got our plan just because we had a lift of markets. Or if interest rates go up 50 basis points, I'm not going to tell you, well, pat us on the back. It would be on a market-neutral basis, assuming normal rise in markets and interest rates exactly where they are. And that I would expect to see progress in some notion of core earnings adjusted for those things. Very significant progress on a year-by-year basis that would make our investors proud.



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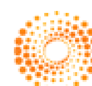

If interest rates in fact do go up, and I believe that they will -- I mean, unless you think the whole western world is going into the Japan scenario, which I think is grossly overblown, but investors can make their own choices -- if interest rates go up, that will be a positive to us. That will reverse some of what we talked about today.

And if equity markets go up faster than the 8% that we've assumed, that in fact will add to that. But I wouldn't expect us to look at those the same way as underlying growth in the businesses -- growing the Asian franchise at the 30% plus growth rates, growing the Canadian business and growing margin, not just sales. And the dramatic retuning that is taking place in the US business.

I mean, our market share of the US mutual fund industry, the biggest in the world, our market share is up 50% from where it was just over a year ago. That is an amazing achievement. And the pension business, very pleased with the direction of it. It doesn't replace -- let's be candid -- it doesn't replace the earnings that we took in at one time from unhedged variable annuity sales. But we are not going back to that paradigm.

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**Tom MacKinnon** - *BMO Capital Markets - Analyst*

Okay. One quick follow-up. I think you used to get credit for swap spreads widening in the quarter, and get hurt, I guess, if they contracted. And that didn't happen in the quarter. Is that because you assume a certain level -- maybe you can just elaborate a little bit more as to why that -- you didn't get that benefit in this quarter.

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Sure, Tom; it is Mike. I will elaborate on that. First, under CGAAP, as you know, we are constantly working to make sure that our methodology is consistent with emerging best practices. And it was evident to us that a lot of companies are grading into long-term of average spreads, particularly since they continue to use long-term average default rates.

We knew we were going to be looking at that at this third quarter as part of the basis change. The short-term fix that we put in place was to basically say if spreads widened out further, since they are already wider than long-term averages, if they widen further, we'll cap those and not take that as earnings credit. And as it turns out, that has been the only quarter that it has mattered this year.

So if we had gone ahead and taken the credit for the widening spreads in the quarter, it would have added CAD380 million positive after-tax to our earnings, but we simply would have been turned around and reversed at Q3 as part of the basis change grading into the long-term averages. We did not think that made sense, and hence, the capping impact that we put in place a little while back impacted this quarter.

Again, when we complete the basis change in Q3, we will work to update the sense for how spreads might help or hurt going forward. Simon, do you want to add anything?

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

No, I think that is a good explanation, Mike. I mean, that was definitely on the corporate spreads. I think Tom might have referred to swap spreads in the question. Swap spreads didn't change very much, so they wouldn't have had an impact. But your explanation of corporate spreads was right on.

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**Tom MacKinnon** - *BMO Capital Markets - Analyst*

If we are looking at single-A corporate rates, I don't know why we look at the spreads on them, too. I can understand the swap spread stuff, and actually they did move in the quarter. But maybe I'll have to follow up with you on that thing.

(Multiple speakers) I guess we don't even -- we should just look really over the single-A corporate rates and not worry about all this credit spread and swap spread stuff when we are going to estimate this going forward.

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

I think -- again, I think going forward, spreads will be relevant. As a general rule, we will be helped by widened spreads -- widening spreads, and we will be hurt by narrowing spreads. They will have a more muted effect going forward because we anticipate moving to a methodology at Q3 where we grade to the long-term average spread.

So rather than assuming that today's spreads are in place for the next 20 years or whatever, we will grade over a relatively shorter period of time to the long-term average. So it will have less of an impact, but widening spreads would still help us. But we've got to get through the basis change and get it onto the new methodology.

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**Tom MacKinnon** - *BMO Capital Markets - Analyst*

So we just look at the government rates?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

I would tend to look at the government rates and the corporate A rates and then, again, let's talk again in three months on those spreads.

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**Tom MacKinnon** - *BMO Capital Markets - Analyst*

Okay, good.

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**Operator**

Mario Mendonca, Canaccord Genuity.

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

Michael, there is $7.2 million of goodwill. I suspect most of that is US-related. Would that be fair?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

That is correct, Mario.

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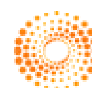

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

You also said that past $700 million of deferred tax assets in the US, something north of that would have you question the recoverability of your deferred tax asset. I am struggling with that, just given if the US profitability can't sustain -- or can't cover $700 million, how does it cover $4 billion or $5 billion of goodwill?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Mario, what is important here is not the overall USA results. It is one particular entity that is a US taxpayer, is where the potential issue is. So please don't misconstrue. I am not talking about JH USA. I am talking about one of the other taxpaying entities on the US tax basis.

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

Okay, so you'd stick by your 1.7 or so, or -- I mean, I know that wasn't guidance, but when you offered a little bit of a hint on the goodwill charge.

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Again, plus or minus $1 billion. Really, I'm not trying to say it is $1.7 billion or whatever. I'm just trying to say I think it will be something -- I saw Sun Life's number. We've obviously done some preliminary analysis. Again, I think that is in the ballpark. But don't be shocked if it is $1.2 billion. Don't be shocked if it is $2 billion. I think it will be that.

And again, whether it is the opening balance sheet for IFRS or whether it is later this year, I know that in some sense doesn't matter in the long term, but it will matter from a geography standpoint whether it is a net income item or not.

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

Okay. And then Don, there have been several references, both on this call and in your press release, to just how much better US GAAP is than Canadian GAAP. Can I take that to mean that if IFRS were, say, not adopted in the US, but were in Canada, the Company would consider adopting US GAAP?

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Well, we already measure on a US GAAP basis our entire enterprise and the numbers that we spoke to in the press release reflect those. Whether we adopt it as our primary reporting basis or not, that's a different thing. Our --

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

Could you?

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Our capital -- we have a regime that we should be very proud of in Canada. It is one of the few places in the world where -- I think it's the only place, actually -- where the accounting basis and the capital basis are consistent, and you don't have a statutory accounting regime as well as a GAAP regime.



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And it is conceivable if IFRS was put in place, there is already discussion that the capital regime accounting basis would have to be separate from that.

But yes, I guess we intend to report on US GAAP for the foreseeable future. It is really amazing how the two bases give you a totally different signal. And I will remind our shareholders and analysts that we don't manage the US GAAP, right? You've got a CAD2.5 billion difference in a quarter. And we don't even manage to optimize it. We'd have a lot of assets, for instance, that show no US GAAP income because of their nature. And we are not even trying to optimize it, and it would be CAD2.5 billion higher.

I think this is an issue for the Canadian government, and they are very aware of it, that life insurance is one of Canada's most competitive industries. We have some great companies here, not just Manulife, but other companies as well, and we can't afford to operate in the United States on a disadvantageous basis because the accounting fraternity in Canada has decided to adopt IFRS without understanding its implications on the various Canadian industries.

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

One final thing. Markets are up, as you pointed out to us, in Q3, and interest rates could very well be up at well at some point in Q3. It is very conceivable there could be a big recovery at some point of the reserves, these non-cash reserves you've put up.

Would it be a disservice to shareholders if rather than taking all of those gains and reporting them in earnings, which, of course, most investors wouldn't pay a ton of attention to anyway because it would be sort of one-time nature -- would it be a disservice to investors to take that and try to really truncate some of this equity market interest-rate sensitivity with out-of-the-money puts, for example?

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Mario, I like the tone of your question, and we are looking at all different ways of hedging this risk. But the essence of your thought is already captured in our strategy. We had the choice, and I had advice from some portion of our investor base when I took over the Company, to put this behind us, to hedge it out. And for me, it was a very easy decision not to do that. And I will tell you why.

Number one, it would have been a gigantic earnings hit. I don't even want to speculate on the size, and the fact is we don't know, but it would have been a gigantic number.

Number two is we would have had to raise equity, most certainly, to fill the hole that was created.

Number three, we would have locked investors out of the opportunity of earning back what they had suffered on the way down. Number four, we wouldn't have gotten any capital credit -- or any significant capital credit. I guess the OSFI regime gives a little bit of credit, but not much, because there is no significant hedging credit; there is a little bit. And if you hedge, you have income that you wouldn't otherwise have. So it is a benefit from that perspective, essentially. But -- and it would have cost our investors very dearly.

I would have loved to put it behind us. That would have been a very strong motivation. What we've elected to do instead is to fortify the balance sheet and to hedge at most opportunistic times. So I've given you a way too long answer, but what I mean to say is if equity markets went up 30% in the next quarter, you can be darn sure that we would be hedging like mad.

We also have built, over the last year and a bit, all the systems to operationalize hedging. Again, it would have been folly on my part -- I'm just going to tell everybody straight up my judgments -- it would have been folly for us to try and hedge the thing out and then discover, holy smoke, there is more complexity to this hedging business than I ever thought. Cash calls, for instance,



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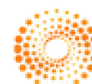

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as equity markets go up, causing you to post collateral against your futures positions and so on. A whole bunch of things, let alone the operational logistics.

I think Manulife had legitimate reasons for being concerned about the impacts of hedging and the unintended consequences. But to not hedge is not an answer either.

So what we've elected to do is what I believe honestly is in shareholders' best interest, to hedge as markets go up. We reserve the right to sort of accelerate or slow down the pace as time develops and our knowledge and confidence in hedging develops. But that is the strategy; whether people like it or not, that is the strategy.

Some investors thought it was too slow. Other investors said, you've raised equity. The last thing I want you to do is go and hedge it out too quickly, and they were worried we would go too fast. We have stuck with the plan, and you can expect that if equity markets go up by substantial amounts that we will hedge a substantial amount more. And also entertain your very legitimate idea of buying out-of-the-money puts, because that is a very simple way of reducing some of that equity market risk. You're quite right.

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

Don, I will just finish up just with one final thing. You said that one of the problems with hedging is that it could result in a really substantial loss in the quarter. But that is precisely what happened this quarter. And you said that hedging would cause you to raise equity. You've raised equity twice. So I'm not sure why that is an explanation for why it is better off for shareholders. Precisely those things you said could go wrong, just went wrong.

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Mario, remember, we had a quarter where we made CAD1.8 billion. We had a quarter where we made CAD1.1 billion. We had a quarter where we made -- we had very near CAD1 billion. If markets reverse, we will have a quarter that is, you know, with a lot of income.

The approach to hedging is that deliberate one that I just described, and I am prepared to have investors tell me that they think we should go faster or slower. That is a reasonable thing to do. But to try and put it behind us for the benefit of management not having to worry about it is not a smart thing to do for shareholders. Trust me.

So we got a lot hedged in the first quarter of this year and in the latter part of 2009. We didn't hedge anything this quarter. Why? Because markets were down, and markets were rising at that time. And it is not just equity markets. It is also swap rates. If swap rates get back to reasonable levels, that enables us to hedge more than we otherwise would.

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**Mario Mendonca** - *Canaccord Genuity - Analyst*

Thanks, Don.

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**Operator**

Andre-Philippe Hardy, RBC Capital Markets.

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**Andre-Philippe Hardy** - *RBC Capital Markets - Analyst*

Thank you. I'm going to start with a technical one. And your ratings are still very strong obviously, but can you talk about the interplay between collateral posting on the now large derivative exposures you have and your rating? Do you post full collateral on the mark to market basis all the time, or if you get downgraded do you have to post more?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Andre, it's Mike. It is not particularly ratings-sensitive. And in terms of the collateral on the equity futures, those tend to be sold in cash in a relatively short period of time. And in terms of the interest rate swaps, yes, we have collateral requirements with the banks. Again, we've got -- at this point in time, given the relatively small size of the interest-rate hedging program, the collateral requirements have not been of material risk across the enterprise. It is something we look at very carefully on a continuous basis.

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**Andre-Philippe Hardy** - *RBC Capital Markets - Analyst*

And would there be a ratings level at which my question would become more relevant?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Not particularly. Not anything that we will get to in the foreseeable future.

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**Andre-Philippe Hardy** - *RBC Capital Markets - Analyst*

And then on the topic of --.

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Bev Margolian is saying not at all -- I guess we should say virtually not at all, just in case there is one place -- but virtually not at all, our Chief Risk Officer said.

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**Andre-Philippe Hardy** - *RBC Capital Markets - Analyst*

And, Bev, that is a function of the exposure to interest rate swaps being small and the rest being almost fully collateralized, right?

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**Beverly Margolian** - *Manulife Financial Corporation - EVP, Chief Risk Officer*

That's right.

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**Andre-Philippe Hardy** - *RBC Capital Markets - Analyst*

Okay. On the objective of increasing returns and/or reducing volatility of earnings, they are often opposite objectives. And we hear a lot of progress on what you're doing with your new business, but the reality is this quarter was horrendous, and the prior quarter really good because of your in-force, not your new business. And how can you accomplish the two objectives on the in-force block at the same time? It seems impossible to me, but maybe I am missing something.



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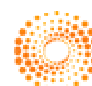


**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

No, you got it, Andre. I described it's a slower process -- I think was Tom MacKinnon's question earlier. You have -- the in-force keeps on growing.

[Technical Difficulties]

**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

So yes, it does take some time to turn around the in-force business. You are absolutely right. What we are doing is changing the new product to have a much more comfortable risk profile. The hedging activity, we've given some estimates on what that could cost us in terms of run rate earnings, if we hedge according to our plan. It is not a killer number. It is a very reasonable number relative to the risk that we are facing. But again, it is market-sensitive; our ability to get there depends on equity markets cooperating.

In the meantime, we are growing businesses very quickly. As we said before, very little of the business in Asia, other than some VAs that were sold in Japan, have the characteristics that we're concerned about. A lot of it is very adjustable. So, that business has been growing very, very quickly.

The business in Canada largely fits the profile of what we like, with some exceptions, and is being looked at in various ways to improve the profile.

The big challenge is in the United States, and that is why our earnings and our adjusted earnings from operations have slowed down a bit, because we've slowed down some of those business activities. But eventually, the things that we are growing will overcome that, and I frankly think that is sooner rather than later.

**Andre-Philippe Hardy** - *RBC Capital Markets - Analyst*

If I ask the question differently, your run rate earnings ex larger moving parts suggests an ROE of about 10% right now. How quickly can profitable new business -- and I believe you are targeting 15% returns on new business -- correct me if I'm wrong -- but how quickly can that move the deal? Are we talking 50 basis points a year or more?

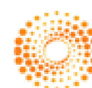
**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Andre, I would love to answer, but I want to make sure that the answer that I give is substantiated by business plans. I could say a number and say what I hope to have happen, but I guess what I would rather do -- and this is what we are going to do in the fall with an investor day -- and have our business heads talk to their plans and, to the degree the lawyers will allow us, talk about what that will do for the earnings progression of this Company and ROE and so on.

And -- but I want to have a high level of commitment and a high level of specificity to the underlying business plans before I say that to investors. And that takes a lot of work and it's also going to take some discussion with our Board to make sure they are comfortable with it. But I don't mind telling you that I feel and the management team feels comfortable that I guess by the end of the year that we are through the worst of it and things will be improving.

And I am also saying it is not something you're going to have to wait three years to see any sign of progress. I guess I'm hoping that we can show that progress more near-term than that.





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**Andre-Philippe Hardy** - *RBC Capital Markets - Analyst*

Thank you.

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**Operator**

Steve Theriault, Bank of America.

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**Steve Theriault** - *BofA Merrill Lynch - Analyst*

Just a couple of quick ones for me, probably for Michael. You have given a 70% hedge target by 2012 for the guaranteed contracts. So I'm trying to get a feel for what you have to do to get there. Is this target predicated on doing a certain amount of in-force hedging, or is it more of that 2.5 years from now some business will roll off and all the new business will be hedged, so you get at least part of the way there? So I guess another way of asking is how the current 51% hedge number would progress by end of 2012 in the absence of hedging the current in-force block.

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

I'll start. Importantly, it would be a combination of hedging the new business, as well as selectively hedging the in-force block. So at this point, all we are sharing with you here is that that is our target, our internal target. It has been for some while. We are simply disclosing it and that we expect to achieve it by year-end 2012.

I wouldn't try to be specific at this point on the pace of that, but I think it is fair to say it will be a combination of in-force hedging along with continued new business hedging.

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**Steve Theriault** - *BofA Merrill Lynch - Analyst*

You couldn't give some sort of a minimum dollar amount at this point?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

I wouldn't at this point, Steve, because, again, it will depend upon a number of different factors. So again, more to come in the future, but I wouldn't try to be more specific at this point.

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**Steve Theriault** - *BofA Merrill Lynch - Analyst*

Okay. One more quick one then, please. You've indicated the long-term care charge in Q3 could exceed your adjusted earning CAD700 million to CAD800 million quarterly target. For it to be that high, are you -- like would you have to lose your tax screens, or could it be that high even if you do get full tax-deductibility on the charge?

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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Steve, the short answer is we don't have the work done yet. So again, I cannot emphasize enough -- there are a tremendous number of judgments that need to be made here. It is still a relatively immature block relative to the ultimate claim. So we've got a lot of work to do to extrapolate future morbidity. Also, as importantly as anything, is projecting the value of in-force rate increases that we expect to get at the state-by-state level. So, we've got a lot of judgments to make. So I really would prefer not to be pinned down. I have really told you at this point what I can tell you.



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**Steve Theriault** - *BofA Merrill Lynch - Analyst*

Thank you. I'll leave it there.

**Operator**

John Aiken, Barclays Capital.

**John Aiken** - *Barclays Capital - Analyst*

Mike, I'm a little bit new to the game here. I was hoping you might be able to explain to me how the lower interest rates actually impact new business strain. Is this -- on the longer-term policies, is this essentially just because of the reinvestment assumed on pricing versus what is actually baked into the actuarial liabilities?

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Yes, John, you've pegged it.

**John Aiken** - *Barclays Capital - Analyst*

Okay. That's great. Thank you.

**Operator**

Colin Devine, Citi.

**Colin Devine** - *Citi - Analyst*

Michael, you just made the comment with long-term care and trying to decide on the assumption changes that it is a relatively immature block in what the impact might be, if I heard you correctly.

**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

That is correct, Colin.

**Colin Devine** - *Citi - Analyst*

And yet, if I think about that block, John Hancock has been writing long-term care for a lot longer than Manulife has been selling secondary guarantee UL or living benefit variable annuities. So, is it going to be even harder for you to assess or frame up the assumption changes on those two liabilities? And specifically, I'm also beginning to wonder in terms of maybe not so much on SGUL; you've touched that, but lapse rates and the assumptions there on your VAs -- or benefit utilization, whichever way you want to look at it.



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**Michael Bell** - *Manulife Financial Corporation - SEVP & Chief Financial Officer*

Colin, I think it is a little bit different animal, long-term care is a little different animal than either long-term care -- excuse me -- long-term care is a little different animal than either variable annuities or the no-lapse guarantee universal life policy.

What I was trying to get at there, and Jim Boyle can correct me, but round numbers, we've got a little over 1 million policies. We only have something like 20,000 that are in claims status. So we are trying to take the claim experience that we've had to date, which the claims on these policies tend to be very, very, very backended, and we are trying to then extrapolate the claims that we have, projecting out claims for the next 40 or 50 years on the million policies.

And importantly, Colin, the sub-blocks that we have, the sub-blocks of long-term care business that we have, are really very different. I mean back before Manulife bought John Hancock, the underwriting practices were not nearly as strict as what they've been post-acquisition. We also had a number of rich plan designs. We had things like lifetime benefits, as opposed to capping benefits at two years or three years or so. We had -- in the old days, we sold a lot of policies with 5% a year escalating benefits; that is something we do very little of today.

So the point is we've got now the more recent block is a much better underwritten, more favorable plan designs. And yet we are trying to project this morbidity out for many, many years on the various sub-blocks, based on some limited data.

Also importantly, nobody can say with 100% confidence exactly what the pace of rate increase approvals will be at the state level. I mean, as Jim said, we had some experience from the last round of rate increases. But again, that is going to be judgment.

So we've got a lot of work to do there. I think that is very different from particularly variable annuities, where we now have some better experience over the last couple of years -- unfortunately, I might add -- but better experience over the last couple of years of what happens when these policies get deep in-the-money. And so I don't -- I wouldn't characterize it as the same kind of risk.

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**Colin Devine** - *Citi - Analyst*

Okay. Then maybe just to clarify, what sort of loss assumption do you have on these deep in-the-money policies? And then the other discussion, I guess question I have for Don, or you, is Sun announced they are getting out of the SGUL business today. Is that also on the table here, that Manulife may shut down some product lines or specifically divest or put up for sale or wind down some of your businesses, such as perhaps reinsurance?

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**Jim Boyle** - *Manulife Financial Corporation - SEVP & President of John Hancock Financial Services*

I would like to add a little color, and then maybe Simon would want to supplement that with some more technical data.

But first, as it relates to experience, and you talk about the universal life business, I think we as a Company and the industry have a lot of experience around mortality. Right? That is principally the experience we lean on there.

The lapses, as Michael referenced earlier in the call, are priced at 1% or lower, and our experience has been relatively good in recent periods.

On the VAs, you know, utilization of the withdrawal benefits, today, we only see less than 12% of the people actually utilizing that benefit. We would've expected that to spike more during this very difficult market period. And frankly, even those that are utilizing are only taking 88% of the available benefit. So they are not even maximizing the benefit, if you will.

Intuitively, you would expect, for example, some challenges around the VAs. But we are still well within pricing on variable annuity.



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And finally, the last thing I would offer on long-term care, just to give you some perspective, there is a distinct difference between US GAAP and Canadian GAAP. And that has come through in this call, and it is very evident here with our long-term care business as well.

If we were a US GAAP reporter, we would be talking about are we in loss recognition mode in this business, and do we have to make some changes to our long-term assumptions. The reality is we are nowhere close to being in loss recognition mode on a US GAAP basis in the long-term care business. But the Canadian regime does make you reflect all of your best estimates kind of in the current period.

So we may seem like a bit of an outlier, signaling some challenges on LTC, but we are still well within the bounds of pricing. Not to say we don't -- we haven't learned that lapses in this business are more likely to be 1% or less than, say, 5%.

So I will pause there. I threw a lot out at you, but there were a handful of questions that you raised.

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**Colin Devine** - *Citi - Analyst*

Thank you.

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**Operator**

Robert Sedran, CIBC.

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**Robert Sedran** - *CIBC - Analyst*

I know it's late, so I'll -- just one quick question for you. I guess OSFI threw out some good news last week in terms of segregated fund guarantees and on the in-force block at the very least. But they did suggest that they are going to come out by the end of the year on new rules for new products.

Are you comfortable that whatever might be coming down would still allow you to earn a 14% or 15% ROE on these things without having to reprice? And if you had to reprice, can you talk a little bit about the price elasticity of demand on these things?

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**Donald Guloien** - *Manulife Financial Corporation - President & Chief Executive Officer*

Robert, those are great questions. The first thing is the new business, the impact is already will be felt as of 2011. And it's going to force us to essentially raise prices on the products. That will put us at a competitive disadvantage in the United States. But as you know, we are not selling a lot of variable annuity right now. We will probably sell less. It is certainly clear that the Canadian standards on the new basis starting in 2011 with respect to new business will be more conservative than US companies operate under. And we will have a disadvantage there; we will have to reflect it in pricing. That is just a reality of the situation.

It doesn't affect the in-force. I think OSFI, quite correctly, came to the conclusion that the changes that they made in 2008 had in them some anti-procyclical features that as markets went up or as -- also, as we came closer to maturity, the CTE levels climbed from, I guess, 90% to much higher numbers. That leaves the in-force reserves quite a bit more conservative than they were back then.

The other thing that they've said is that three years from now they expect to have a whole different standard. But we think that is a good approach, because the new standard, they've indicated they will give enhanced hedging credit, in all probability. We don't know how much, but some credit for hedging.



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They've also indicated that they will look at the calibration criteria because right now, what we do is use a stochastic model to determine the amount of capital, and then you say -- you multiply it by 1.5 to get up to the regulatory action level. And then you say, well, you want a nice distance between that, so you add on an arbitrary buffer for say a 30% market decline and then you sort of look at how far you are from that.

And I think if you look end-to-end in that process, when you actually look at what we call the stacking of conservatism on the basic stochastic model, I mean we don't know. It may take us very close to 100% confidence level, which is probably not appropriate as a standard.

So I think OSFI quite rightly has said we really want to take -- we want to send out a signal, a strong signal, that you shouldn't be building your franchise based on VA sales. That is very clear from the impact on new business. And we reserve the right to see what we will do with the whole package three years from now, but they want to take a look at every element of it, so that we come up with a -- I think a sense -- so they come up with a sensible regime.

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**Robert Sedran** - *CIBC - Analyst*

That's helpful, Don. I guess I will leave it there. Thanks.

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**Operator**

Michael Goldberg, Desjardins Securities.

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**Michael Goldberg** - *Desjardins Securities - Analyst*

My question got asked and answered. Thanks.

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**Operator**

Darko Mihelic, Cormark Securities.

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**Darko Mihelic** - *Cormark Securities - Analyst*

Don, I'm sorry. Given the length of the call, my question is far too technical. I'll ask off-line. Thanks.

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**Operator**

Thank you. There are no further questions registered at this time. I would now like to turn the meaning over to Mr. Ansari. Please go ahead.

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**Shad Ansari** - *Manulife Financial Corporation - Assistant Vice President, IR*

Thank you, operator. We will be available for any additional follow-up questions, so have a good afternoon everyone.

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**Operator**

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



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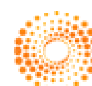

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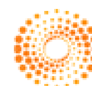

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