Rating Report

Navy Mutual Aid Association

Rating
Insurer Financial Strength.................. A+

Rating Outlook
Stable

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■ Summary Rationale

Navy Mutual Aid Association's (NMAA) 'A+' insurer financial strength rating reflects its sound capital, favorable business profile and strong niche position as a low-cost provider of insurance protection products to active, reserve and retired members of the U.S. Navy, U.S. Marine Corps, U.S. Coast Guard, U.S. Public Health Service (USPHS), National Oceanic and Atmospheric Administration (NOAA) and their families. NMAA offers mainly interest-sensitive whole life and term life insurance, and provides high-quality service and financial security education to its members. In recent years the association has offered annuity products as well.

Fitch Ratings views as additional strengths NMAA's conservative reserving, outstanding persistency, low mortality, consistently low expense ratios and a high-quality, liquid bond portfolio. Fitch believes that NMAA's "war risk" is being prudently managed and mortality experience is within expectations despite the current conflict in Iraq.

Rating concerns include NMAA's flattening growth in membership and moderate surplus volatility. Fitch notes that while membership growth has been relatively flat over the past three years, NMAA's premiums and insurance in force have increased due to the popularity of NMAA's family plans, competitively priced products and value-added service to its membership.

NMAA's reserve profile and member focus are key factors in NMAA's investment strategy, which includes a moderately higher-than-industry-average allocation to common stocks and a longer-than-average bond portfolio duration. This strategy has helped maintain the association's strong dividend rates in recent years but also moderately increased surplus volatility and interest rate risk. Fitch notes that NMAA has increased the investment portfolio diversification in 2006 as a strategy to mitigate exposure to common stock price volatility.

NMAA is headquartered in Arlington, Va., and reported total admitted assets of $2.0 billion and adjusted surplus of $158 million at Dec. 31, 2005. The association currently has approximately 100,000 members and more than $14.4 billion of insurance in force.

■ Rating Expectations

The Rating Outlook is Stable. Fitch expects that in 2007 NMAA will maintain solid capital levels and a high-quality, liquid balance sheet, as well as maintaining its strong niche position through its value-added products and an increased focus on high-quality service to its membership. Fitch expects NMAA to report solid operating performance in 2007, driven by low expenses and good levels of investment income.

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Company Overview

NMAA is an association, with eligible membership that currently includes all uniformed personnel of the Navy, Marine Corps, Coast Guard, NOAA and USPHS, including all enlisted and officer grades, regular, reserve and retired. NMAA has headquarters in Arlington, Va., and a branch office to service members at the Norfolk Naval base in Norfolk, Va.

NMAA is a member association created in 1879 to provide life insurance for the families of naval officers, as private insurance was rarely available to them at that time. The association was created by an act of Congress and is not a licensed insurance company. Membership expanded to the active reserves in 1920, Coast Guard in 1925, women officers in 1947, USPHS and NOAA in 1963, enlisted personnel in 1980 and retirees/inactive reserves in 1993. In addition, members could purchase life insurance for spouses beginning in 1985, and for their children and grandchildren beginning in 1996.

While NMAA currently has approximately 100,000 members, about 40% of all members are on active duty in the various services represented in NMAA. Fitch believes that the expected future decline in naval manpower could make it more challenging for NMAA to expand its membership base and grow premiums. NMAA's pool of eligible insureds was expanded in 1996 to include the children and grandchildren of members. Members can insure their children and grandchildren with an interest-sensitive whole life policy from NMAA, which is positioned as a way to help pay for the costs of a college education.

Fitch views NMAA as serving a unique niche in terms of customer base and customer services. It has maintained a close relationship with the sea services and has avoided the market conduct issues that have plagued several other associations and commercial insurance companies that target the military market. (Some competitors have been banned from marketing on military bases because of sales conduct issues.)

NMAA's main competitors include the Serviceman's Group Life Insurance (SGLI) program, benefit societies and commercial insurance companies that typically target members of the military. As a result of its low cost structure and excellent mortality experience, NMAA's insurance policy rates and benefits compare very favorably with each of these competitors.

Fitch considers NMAA to have a secure position in its niche as a nonprofit provider of insurance protection and services for its membership based upon its quality service, efficient operations and exceptionally competitive insurance products. The association's crediting rates and term premium refunds provide member value and build member loyalty.

Products

NMAA serves its defined market with an uncomplicated selection of insurance and annuity product offerings. It also provides related informational services including survivor assistance, financial planning, financial services, entitlement education and federal benefits education.

NMAA currently offers two basic life insurance products: interest-sensitive whole life insurance and term life insurance. Additionally, the association offers a number of death benefit settlement options for beneficiaries, as well as offering an accelerated death benefit option and a long-term care option. With the accelerated death benefit option, the policyholder can convert the death benefit of the policy to an accelerated payout option. The association structures the payout so that it is revenue-neutral, illustrating that NMAA's focus is service to its members, whatever their needs.

NMAA is increasing its membership base and revenue through the introduction of a number of member-requested products, such as rated plans on its Permanent "Plus" products, new versions of its Level II "Plus" Term product and increased maximum coverage limits for members and spouses.

Product Profile

	Products	
	Individual Life	Individual Annuity
Markets		
Individual	X	X
Financial Data ($ Mil.)		
General Account Reserves	1,620	153
Separate Account Reserves	0	0
Premiums and Deposits	42	18
% of Total	69	31
Distribution		
Direct	X	X

Fitch also notes NMAA's controlled entry into the individual annuity market with three product options for its membership. In recent years, NMAA diversified its product portfolio with the offering of a single-premium deferred annuity (SPDA), a flexible-premium deferred annuity (FPDA) and a single-premium immediate annuity. These individual annuity products include a single-premium deferred annuity with various interest rate lock-in periods, a market-value adjustment and no surrender charge for early, full withdrawals. Also offered is a simplified single-premium immediate annuity. While these products have attractive crediting rates versus competitors' annuity offerings, sales have been slower than expected due in part to the favorable crediting rates on NMAA's interest-sensitive whole life products.

The long-term care option is offered to all members or spouses who have been insured with an interest-sensitive policy for at least two years, are at least 60 years old, have been in a long-term care situation for at least four months and are likely to be in that situation permanently. The death benefit, less any loans, can be converted to an annuity payout for a specified period. This feature also benefits NMAA, as members are provided with a disincentive to cash out their policies. There is no additional fee for inclusion of this provision, nor is there any charge for its exercise.

Distribution

New plans are generated through two main sources: direct marketing and member referrals.

New members are obtained via member referrals, print media ads, direct mail, Web-based advertising and via NMAA's Web site. Approximately one-third of new members result from direct mail and one-fourth join because of NMAA member referrals.

NMAA's sales are conducted only by salaried employees out of its home office. As a part of its mission to provide education to its membership concerning government survivor and retirement benefits, NMAA makes approximately 500 presentations to an estimated 25,000 service members annually. If, after a presentation, a service member is interested in buying a policy from NMAA, that person must contact the home office for an application. While this low-key sales approach might hinder growth, it has made the organization nearly immune from charges of improper sales practices.

Fitch views growth in new members as one of NMAA's intermediate-term challenges, as membership has hovered around the 100,000 level for the last five years. In recent years NMAA's Career Assistance Program (CAP) has declined as an important generator of new members. Fitch believes that NMAA's strategic plan to increase the communication of its need-based value proposition and continued excellent service and education, which began in 2006, will have a beneficial effect on new membership levels.

Financial Review

Operating Performance

Fitch views NMAA's operating performance over the past three years as good, characterized by consistent, moderate pre-dividend gains from operations and moderate premium growth. Key drivers were low expense levels, good investment income and favorable persistency.

As a mutual entity, the association does not generate a significant statutory net operating gain. NMAA allocates revenue in excess of that required by its financial plan for required reserve and surplus

Operating Performance
($ Mil.)

	2001	2002	2003	2004	2005
Total Premium Income and Deposits	37	42	41	59	60
Investment Income	100	105	110	116	123
Total Revenue	137	146	151	175	183
Gain Before Federal Income Tax and Dividend	40	35	26	32	37
Policyholder Dividend	38	30	24	23	26
Pretax Operating Income	2	6	2	7	8
Federal Income Tax	0	0	0	0	0
Net Operating Gain	2	6	2	7	8
Realized Capital Gains	(2)	(3)	3	0	18

Note: Statutory accounting principles. Source: Navy Mutual Aid Association.

Operating Ratios
(%)

	2001	2002	2003	2004	2005
Return on Average Adjusted Surplus	1.9	5.6	2.3	5.1	5.4
Pretax Return on Total Assets Pre-Dividend	2.7	2.3	1.6	1.8	2.0
Pretax Return on Total Assets Post-Dividend	0.15	0.35	0.14	0.53	0.56
Pretax Operating Margin	1.6	3.8	1.6	3.9	4.4
Expense Ratio	0.4	0.4	0.4	0.4	0.4
Federal Income Tax Rate	—	—	—	—	—
Net Investment Yield	6.92	6.92	6.85	6.72	6.78

Note: Statutory accounting principles. Source: Navy Mutual Aid Association.

increases to increase the cash values of its interest-sensitive whole life policies and to provide premium refunds on its term policies. While the excess revenue flows through the association's income statement as an operating loss, NMAA could redirect this excess revenue to its surplus base. Crediting rate decisions are normally made once a year, but NMAA has the flexibility to respond to changing interest rates or the need to retain surplus. The association has demonstrated this flexibility by modifying its crediting rates to reflect changes in interest rate levels and investment portfolio performance.

NMAA exhibits a substantial cost advantage versus many life insurers, as evidenced by its very low expense ratio (expense to assets) of 0.4%. A number of factors contribute to this low cost structure, including its low overhead, its lack of commissioned agents, its classification as a 501(c) (23) organization exempting it from federal tax, and its regulatory exemption by the Virginia legislature that recognizes its mission to provide coverage to sea service members and their families. In addition to low expenses, NMAA also benefits from a low mortality rate, reflecting the generally healthier population segment that NMAA is targeting and a stringent medical underwriting process.

Investments and Liquidity

Fitch considers NMAA's investment portfolio to be conservatively managed and the asset mix to be appropriate for its product liabilities and investment strategy. Fitch believes NMAA's invested assets have low exposure to credit risk and modest exposure to equity market volatility and changes in interest rate levels. The majority of invested assets are managed internally by NMAA.

Fitch notes that NMAA has taken additional steps to reduce the moderate surplus volatility caused by market value changes in its equity investments and also to reduce single-issuer credit risk in its bond portfolio. The association made marginal adjustments to its equity portfolio with the addition of three new equity-index funds with low expected return correlations to existing funds and also initiated a portfolio allocation to the real estate class. NMAA also increased the diversification of its bond portfolio through the addition of new industry sectors and marginally increased its allowable allocation to investment grade, 'BBB'-rated bonds over time. A securities lending program was also initiated in 2006 and is expected to add marginal investment income.

Fitch views the association's investment performance as good. The invested asset investment yield of 6.7% compared quite favorably with the life industry's average yield of 5.7%, due in part to its longer-than-average duration and low exposure to callable bonds and mortgage-related securities. Realized losses related to credit impairments have been minimal and have compared very favorably with the life insurance industry during the unfavorable credit cycle of 2002–2003.

The association's bond portfolio is composed of assets that are of very high credit quality. More than one-third of the bond portfolio was invested in U.S. Treasury and federal agency and government-sponsored enterprise securities at Sept. 30, 2006. The investment policy assures that only companies whose bonds are rated 'BBB' or better and with a Stable-to-Positive Rating Outlook are eligible for purchase, with a limit on investment in 'BBB'-rated bonds of 15% of the bond portfolio. The ratio of below-investment-grade bonds, at 23% of adjusted surplus, is low when compared to the 2005 life and health insurance industry average of approximately 50%.

The bond portfolio typically exhibits a long duration to better match the life insurance-dominated liability portfolio. The long duration of assets exposes NMAA to interest rate risk, but this risk is reasonable since yields on these assets are normally well above

Investment Portfolio
($ Mil.)

	2001	2002	2003	2004	2005
Total Invested Assets	1,499	1,536	1,685	1,812	1,919
% Bonds	81.6	82.5	83.7	84.2	85.6
% Common and Preferred Stock	6.2	6.0	6.4	6.8	6.9
% Mortgage Loans	1.0	0.8	0.5	0.3	0.3
% Real Estate	0.3	0.3	0.0	0.0	0.0
% Policy Loans	7.8	7.6	7.1	6.6	6.6
% Cash and Equivalents	0.3	0.7	0.3	0.4	0.4
% Affiliated Investments	0.0	0.0	0.0	0.0	0.0
% Other Invested Assets	2.7	0.0	2.0	1.6	1.6
Asset Quality					
Below-Investment-Grade (%) TAC	18.4	33.3	25.8	14.3	23.1
Troubled Real Estate % TAC	0.0	0.0	0.0	0.0	0.0
Nonaffiliated Equity % TAC	86.0	102.9	90.0	86.1	90.0
Risky-Asset Ratio	87.5	134.9	115.8	100.4	113.1

TAC – Total adjusted capital. Note: Statutory accounting principles. Source: Navy Mutual Aid Association.

minimum yields required to fulfill the liability requirement, thus minimizing the reinvestment risk.

NMAA's equity investments consist entirely of broadly diversified, indexed mutual funds, and historically have been a key driver of excess interest crediting rate levels. NMAA's investment policy limits common stock to a maximum 100% of surplus plus equity-attributable asset valuation reserves. Fitch believes this policy will control potential additional common stock investment in future periods of strong asset growth.

In addition NMAA limits its aggregate investment in common stocks, direct mortgages and private real estate trusts to 8% of total investments. Fitch believes that while NMAA's higher-than–industry-average allocation to common stocks is not an unreasonable long-term investment strategy, considering the liability profile and a smaller allocation to other higher-risk assets such as mortgages and real estate, it does add volatility to NMAA's surplus position. Directly placed mortgage loans accounted for only 0.3% of NMAA's investment portfolio and all loans are in a performing status.

Fitch considers NMAA's asset liability management to be sound. NMAA's signature product is its interest-sensitive whole life insurance policy and recent product additions include a modest line of annuity products. The association conducts cash flow studies under a variety of interest rate scenarios and equity market scenarios to ensure that its cash flow matching is sufficient to mitigate any potential disintermediation. Under its most severe interest rate scenario, management determined that the composition and distribution of its investment portfolio was more than sufficient to meet its cash flow demands without any undue harm to its financial strength or adverse effect on the cash values of its existing members.

Fitch believes NMAA's liquidity is very good due to the composition of the invested assets and conservative product design features. The investment portfolio is composed of more than 92% cash and publicly traded securities. NMAA's product design features high crediting rates on the interest-sensitive whole life policies and various settlement options that pay above-market interest rates, providing added incentive for members to leave their money with NMAA. Additionally, good levels of cash flow from operations provide an added level of comfort regarding the protection provided to policyholders.

Leverage and Surplus
(x)

	2001	2002	2003	2004	2005
Assets/Adjusted Surplus	14.0	18.3	14.2	12.8	12.3
Adjusted Liabilities/Adjusted Surplus	12.9	17.1	13.2	11.8	11.4

Note: Statutory accounting principles. Source: Navy Mutual Aid Association.

Capitalization
($ Mil.)

	2001	2002	2003	2004	2005
Beginning-of-Period Total Adjusted	121	109	91	121	144
Net Operating Gain	2	6	2	7	8
Realized and Unrealized Gains	(15)	(24)	27	15	5
Change in Reserve Valuation	0	0	0	0	0
Paid-in Capital/Surplus	0	0	0	0	0
Dividends to Stockholders	0	0	0	0	0
Other Changes	1	1	0	1	1
Total Changes	(12)	(17)	29	23	14
End-of-Period Adjusted Surplus	109	91	121	144	158

Note: Statutory accounting principles. Source: Navy Mutual Aid Association.

Capital Position and Profile

Fitch believes NMAA has sound capitalization with respect to its risks and liabilities. However, changes in year-to-year reported adjusted surplus have experienced moderate volatility over the past five years, due to the changes in market values of its common stock holdings. Fitch believes the 2006 investment allocation modifications will have a favorable effect upon this volatility.

Fitch views NMAA's estimated risk-adjusted capital ratio as strong at approximately 300% of the company action level at year-end 2005. Fitch believes this level provides solid policyholder protection and is understated. When the reserve for war risk and other adverse deviations is included, adjusted risk-based-capital (RBC) exceeded 400% at year-end 2005. While NMAA carefully monitors and manages its risk-adjusted capital levels, as an association, it is not regulated as an insurance company

For the five-year period ended Dec. 31, 2005, adjusted surplus has grown at a 5.0% compounded annual growth rate (CAGR), despite the high crediting rate paid out to participating policyholders. A significant portion of this high payout has been generated by realized and unrealized capital gains from its common stock portfolio. Fitch believes that management has the flexibility and discipline to adjust dividend rates if necessary to maintain strong levels of capital. The association employs conservative reserving practices as well.

Fitch considers NMAA's $61 million voluntary reserve for war risk and other adverse deviations as additional support for the rating. This special reserve was established to protect against long-term excessive claims due to war and/or other risks and adverse investment yield scenarios.

Fitch believes that NMAA's "war risk" is being prudently managed and mortality experience is within expectations despite the current escalated levels of conflict worldwide in recent years. Since its inception, NMAA has been exposed to the possibility of catastrophic losses that could result from war. NMAA estimates that less than 20% of its current in-force book of business is currently eligible for war risk. Fitch believes that NMAA's current war reserves and mortality margins could experience a significant increase in adverse results for a sustained number of years without requiring additions.

NMAA has historically used a catastrophic reinsurance policy from a highly rated insurance company to mitigate its exposure to any potential catastrophic losses occurring during a war. While current pricing of such coverage is not deemed attractive, NMAA continues to seek reasonable and cost-efficient levels of excess-loss/catastrophe insurance coverage. Fitch believes that such coverage is a prudent hedging of mortality risk.