Fitch calls U.S. life industry “stable,” but notes concerns

By Editor Test *Mon, Dec 19, 2011*

"The industry’s large in-force book of variable annuity business will continue to be a drag on profitability over the near term," the ratings agency said in a recent bulletin.

In a new bulletin, “2012 Outlook: U.S. Life Insurance,” Fitch Ratings calls industry “stable,” but says it expects the “positive trends in industry earnings performance and investment results reported in 2011 to be pressured in 2012 due to the low interest rate environment, increased hedging costs, and ongoing market volatility.”

Among other things, the bulletin said:

- Fitch expects that the industry’s large in-force book of variable annuity business will continue to be a drag on profitability over the near term. It could also cause a material hit to industry earnings and capital in an unexpected but still plausible severe stress scenario.
- Near-term impacts due to low interest rates include reduced interest margins and increased statutory reserving associated with asset adequacy testing which could reduce statutory capital level by up to 5% in the fourth quarter of 2011. Insurers with defined benefit pension plans for their employees will face increased pension funding expenses in 2012.
- Fitch remains concerned about the risk profile of the variable annuity (VA) business. Through the sale of VA products with secondary guarantees, insurers effectively have a short embedded-equity put exposure, the value of which is sensitive to interest rates and volatility.
- Leading up to the 2008–2009 financial crisis, a key concern was the effectiveness of the industry’s variable annuity hedging programs. While the hedging programs that were in place were generally effective in mitigating losses from VA embedded guarantees, the industry was clearly under-hedged, relative to certain risks, and did experience a degree of hedge ineffectiveness.
- Fitch believes that the industry has strengthened and expanded the scope of the VA hedging programs following the financial crisis. However, the industry’s hedging programs continue to be challenged by policyholder behavior risk, hedging costs, sensitivity to tail risk, and the long dated nature of the liability.
- Policyholder behavior risk relates to pricing assumptions on lapsation, living benefit utilization, and mortality. Emerging experience is indicating that the industry’s assumptions may have been too aggressive, as a number of insurers have increased reserves in 2011 to reflect emerging experience. Fitch expects this trend to continue.

Andrew Davidson, CFA, one of the Fitch analysts who wrote the report, shared his views with RIJ about the charges against earnings and other adjustments that some life insurance companies reported at the end of the third quarter of 2011, as a result of changing market conditions and emerging trends in policyholder behavior.

“The products’ benefit features often have delayed benefit options, and the policyholders are just beginning to make decisions about them. The companies priced certain assumptions about utilization of benefits, and they’re in the process of getting more data points about it, and of adjusting their assumptions to match their experience,” he said.

“That’s what’s going on right now. If they made accurate assumptions, they don’t need to make reserve changes. It’s a company-by-company issue. A Prudential or a MetLife has more diversification of business outside of variable annuities than some other companies.

“Some companies will target hedging to reduce volatility in income, others to protect statutory capital, others to protect economic value of their book of business, so it’s difficult to make comparisons between companies. If the charge is not outsized in comparison to the book of business, ratings would not likely be affected. The companies can also make adjustments to their books of business.

“When you add to reserves it comes out of capital, so from a financial perspective you’ve got less capital. So the higher reserve and the lower capital are more representative of the true economics. The hedges offset some of the need for reserves; if hedging is not effective you have to reserve more.”