
Fitch Deems Life Insurers "Stable"

By Editor Test *Wed, Sep 8, 2010*

Fitch expects the industry's large in-force variable annuity business to hurt profitability over the near term, however, and could damage industry earnings and capital in an unexpected, but still possible, severe stress scenario.

Fitch Ratings has upgraded the outlook for the U.S. life insurance sector to stable from negative. The negative outlook was initially assigned in September 2008. A stable outlook for the sector indicates that Fitch believes a vast majority of insurer ratings will be affirmed as they are reviewed over the next 12-18 months.

A special report published today, 'U.S. Life Insurance Sector: Outlook Revised to Stable' is available at www.fitchratings.com.

Over the next 12-18 months, Fitch's primary rating concerns for life insurers include:

- Uncertainty over the economic outlook and the potential for a double-dip recession.
- Higher-than-expected losses on commercial real estate (CRE) related assets.
- Emerging interest rate risk due to historically low interest rates, which are having an impact on industry investment yields, and uncertainty regarding the direction of future interest rates.

The Stable Rating Outlook for the U.S. life insurance sector reflects the industry's improved balance sheet and operating fundamentals. Fitch notes that sustained improvements in investment valuations and financial market liquidity has resulted in a significant reduction in investment losses, and allowed the industry to raise capital and fund near-term maturities.

Fitch expects that favorable trends in industry earnings performance and investment results in 2010 will continue over the near term, but will continue to lag pre-crisis results due to the lower interest rate environment and steps taken by the industry to lower risk in the investment portfolio by reducing investment allocations away from higher risk, higher return asset classes.

Results in 2010 have benefited from improved interest margins, higher equity market valuations (relative to prior year), and the aforementioned decline in investment losses. Fitch expects the industry's large in-force variable annuity business to be a drag on profitability over the near term, and could cause a material hit to industry earnings and capital in an unexpected, but still possible, severe stress scenario.

Fitch views the passage of the Dodd-Frank bill earlier this year as credit neutral for life insurers but recognizes that uncertainties remain over the interpretation of several aspects of the bill. Primary concerns include the potential designation as a systemically important non-bank financial institution and its implications, and the uncertain impact on industry sales practices, particularly for registered products.

The outlook revision also considers the positive steps taken by a number of life companies to de-risk their product offerings, reduce reliance on institutional funding sources, and strengthen hedging and other risk

mitigation programs.

Since the September 2008 shift of Fitch's U.S. life insurance industry rating outlook to negative, Fitch has downgraded 35 out of 55 rated U.S. life insurance groups one or more times. Over the same time period, Fitch has upgraded two U.S. life insurance groups. The large majority of the rating downgrades during this period were limited to one to two notches. While ratings of U.S. life insurers have been broadly affected by the financial crisis, the limited magnitude of the rating downgrades reflected the industry's relatively stable liability structure and strong capital position going into the credit downturn.

Fitch's sector outlook assumes a continued, albeit weak, economic recovery with modest GDP growth and continued high unemployment levels. Fitch's outlook does not incorporate exogenous shocks to the economy, and will factor in such events should they occur. Fitch's expectation for CRE-related investment losses are closely tied to Fitch's economic assumptions. Fitch continues to believe that the industry's CRE-related loss exposure is manageable and has been reasonably factored into existing ratings under Fitch's stress testing methodology.

From the perspective of interest rate risk, over the near term, minimum rate guarantees incorporated in the policyholder accounts of the U.S. life insurance industry will limit the ability of life insurers to maintain interest margins due to low investment yields. Longer term, Fitch is concerned that strategies that life insurers may be using to reach for additional yield will make them vulnerable to disintermediation and asset-liability mismatches in a rapidly rising interest rate environment. Such strategies could include extending portfolio durations and asset-liability mismatches, accepting higher levels of lower rated securities, and amassing sector concentrations.

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