Hazards may lie ahead for life/annuity industry: AM Best

By Editorial Staff *Thu, Jul 11, 2019*

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A new special report from AM Best, the insurance ratings specialist, evaluates the readiness of the life insurance and annuity (L/A) industry to weather an economic storm like that of 2008-2009. Firms are “more resilient” than a decade ago, but some of the pre-conditions of the Great Financial Crisis (GFC) have reemerged, the report said.

Looking back over the past decade, the report (“Are Life/Annuity Insurers Prepared to Weather Another Economic Downturn?”) notes that the L/A industry adjusted to the GFC in part by shifting its product mix toward fixed annuities from variable annuities.

Between 2007 and 2018, for instance, the percentage of total annuity premiums going to variable annuities dropped to about 40% from about 60%. Fixed products have fewer options for owners, owner behavior is more predictable, and the market risks associated with general account products are more manageable.

As part of their re-stabilization process, insurers also raised their holdings of investment grade quality bonds to pre-crisis levels. Many L/A insurers maintained liquidity by reducing holdings of collateralized mortgage obligations and increasing holdings of cash, cash equivalents, and U.S. government securities. Corporate bond holdings also rose.

But new risks have emerged. Within the investment grade category, insurers have steadily increased their allocations to Class 2 bonds, with BBB rated bonds having the highest exposure. Allocations to untested assets such as collateralized loan obligations and holdings in mortgage and alternative assets have also increased.

The L/A industry also will face several accounting and regulatory changes over the next few years, the report said. Term products likely will see relief from less redundant reserves, and variable annuity reserves and capital requirements will change to better reflect the economic benefits of hedging and eliminate non-economic volatility.

Companies were already identifying the need to improve legacy technology and upgrade systems before the financial crisis. AM Best expects that pace of such changes will quicken as technological advances create more opportunities to accomplish these goals.

The new report also reviews the chain of events that led to the 2008-2009 crisis. In 2006, after the industry had enjoyed several years of tailwinds, economists begin warning about global economic volatility, credit cycle downturns, and possible corrections in equity markets. An inverted yield curve, which may presage a recession, also appeared in 2006.

Macroeconomic conditions in the United States deteriorated as the effects of the subprime crisis emerged. Loan securitizations flooded the financial system at a time when new loans, and the securities derived from them, began to challenge market stability and diminish companies' ability to manage risk effectively.

The same thing could happen again, AM Best warned. The current geopolitical, interest rate, and equity market environment resemble those of 2007 in some ways, possibly leading to higher economic volatility. Available capital also has grown steadily since the financial crisis; however, as economic conditions change, so may risk charges.