It’s a drag: Low rates weigh on life insurer earnings

By Editor Test *Mon, Jul 23, 2012*

“Operating earnings in the individual annuity segment were generally lower in 2011,” said a new report from Fitch Ratings, “as extreme equity market volatility in the second half more than offset strong results through the first half in the variable annuity line of business."

The strong equity market helped perk up variable annuity results improved in the first quarter of 2012, but choppy market performance in the second quarter made that trend unlikely to last, according to a recent bulletin from Fitch Ratings.

And weak annuity results won’t do much for the insurers’ bottom lines. “Annuity earnings are expected to be a drag on overall earnings over the near term given market volatility and low interest rates,” wrote Fitch analysts in a July 17 Special Report entitled “Earnings Outlook Mixed for U.S. Life Insurers.”

“Operating earnings in the individual annuity segment were generally lower in 2011,” the release report said, “as extreme equity market volatility in the second half more than offset strong results through the first half in the variable annuity line of business. Fixed annuity interest margins benefited primarily from lower crediting rates.”

The report included the following highlights:

Expect Modest Improvement in Industry Operating Returns. Fitch Ratings anticipates modest improvement in industry profitability in 2012 driven by growth related to prior-year international acquisition activity at a few companies, continued reduced crediting rates in most product lines, product redesign and pricing and ongoing expense management. Fitch believes insurers face an uphill battle in materially improving returns and earnings-based interest coverage metrics in 2012 due to macroeconomic headwinds.

Interest Rates Remain a Drag. Interest rates remain at historically low levels. This could continue at least through 2014, based on recent Federal Reserve statements. The low rates are a major drag on earnings, reducing net investment income and interest margins on spread-based products. It also increases hedging costs as well as employee pension liabilities and reserve requirements for a number of products due to reduced expectations for investment returns and future profitability.

Repositioning for the New Normal. Prolonged low interest rates, strategic repositioning, and emerging regulatory capital requirements out of Europe have caused several companies to exit or pull back from the fixed and variable annuity, universal life with no lapse guarantees, and other interest-sensitive lines of business. The ongoing exit from the long-term care business continued in 2011 due to the impact on profitability of low interest rates combined with adverse morbidity experience.

Equity Markets Remain Volatile. Asset-based fee income was positive through the first quarter of 2012 primarily due to higher account values and equity market appreciation. The market gyrated in the second quarter but remained positive for the first half of the year. It was not at all clear where the market was heading in the second half. Increased volatility has raised hedging costs, particularly for variable annuity writers with significant guarantees.

New DAC Rules Add to Pressure. On Jan. 1, 2012, most U.S. life insurers retrospectively adopted new accounting guidance designed to address inconsistencies in the way companies were accounting for deferred acquisition costs (DACs). The adoption reduced previously reported first-quarter 2011 pretax GAAP income by an average of 9%, based on filings of a sample group of large life insurers. It also resulted in an average 8% decline in the previously reported 2011 GAAP equity.

Slow Economy Keeps Pressure on Group Market. A number of companies have seen long- term disability loss ratios increase, and that is expected to continue. Some are now citing economic conditions, including continued high unemployment and slow growth, as a driver of higher loss ratios. No clear patterns have emerged as of yet. A number of companies have responded with significant price increases.

Lower Investment Losses: The bright spot is that realized credit-related investment losses continue at reduced levels. Commercial mortgages are generally performing well, although there is an increase in troubled real estate as a percentage of total adjusted capital (TAC) for the industry as a whole. However, overall risky assets in relation to TAC were flat in 2011. Fitch believes that companies are starting to take a little more risk in 2012 in the search for yield, particularly through allocations to longer term bonds and alternative investments. Mortgage origination is also up.