It’s a Twister, Auntie ‘Ben’

By Kerry Pechter *Tue, Nov 8, 2011*

U.S. life insurers can weather the impact of 'Operation Twist' for a few years, Moody’s Investors Service says. But another five-plus years of rock-bottom interest rates could damage profits and ratings.

“Operation Twist” and its monetary policy predecessors are keeping life insurers in a whirl.

In just the past ten days, MetLife said it would lower the deferral bonus on its hottest living benefit rider, Sun Life Financial was placed under “negative watch” and American Equity Life, a big issuer of fixed deferred annuities, announced its first rate renewal reduction since 2007.

A stream of similarly dismal announcements is expected in coming months as more insurers adjust to the impact of the Federal Reserve’s decision last August to keep interest rates, including long-term Treasury rates, suppressed until at least 2013.

Observers like Neil Strauss of Moody’s Investors Service don’t expect low yields to create an immediate crisis for life insurers. But companies will feel pressure as they scramble to either find ways to maintain profit margins by raising prices or reduce profit expectations.

“This is not a crisis, but there will be pain,” Strauss told *Retirement Income Journal* this week.

If rates stay down for five years or more, however, life insurers could be more severely hurt, said Strauss, the author of Moody’s August 19 report, “Protracted Low Interest Rates Would Present Major Risks for U.S. Life Insurers.”

“It would take a few years for this to become an issue where we would take action on our ratings,” Strauss said. “We say in the article that it’s not a major issue in the short term. Should rates stay low of five years or less, it can be dealt with.

“It takes a while for companies’ portfolios to turn over and to reassess DAC [deferred acquisition cost] assumptions. But in the meantime, they still want to make their pricing targets and minimize their losses.”

Sun Life’s new rider

To a degree, life insurers have the consolation that they and their competitors face the same problem. On the other hand, manufacturers of certain products will feel the impact of Fed policy more sharply than others, according to Moody’s.

Those include producers of fixed-rate deferred annuities and of “long-tailed annuities” with “embedded interest rate guarantees (such as unhedged ‘rho’ embedded in variable annuities with guaranteed minimum income benefits or death benefits), and long-term care/long-term disability income products,” said the Moody’s report.

Canadian-owned Sun Life Financial, a leading variable annuity issuer, announced a third quarter loss of $621 million as a result of falling interest rates and equity prices, and was placed “under review” by A.M. Best. Under Canadian accounting rules, Sun Life also had to reserve an additional $500 million against the lifetime costs of hedging its guarantees.

“As a Canadian-owned company, we’re operating under a more conservative and more onerous standard,” Deschenes told RIJ. “We’re present-valuing a lot of the changes into a single quarter and accepting the increase in reserves. In the U.S., you can smooth that impact over time and build in the potential for mean reversion.”

Not coincidentally, the Wellesley, Mass.-based company last week announced a new variable annuity rider that will cost much less to hedge. The new Vision variable annuity has no deferral bonus and offers a payout of just 4% per year for life at age 65.

But it also allows up to a 70% equity allocation and the living benefit rider costs only 35 basis points for a single life and 50 basis points for joint life.

“You can’t offer the same products in a two percent environment that you can in a 3.5% environment,” Deschenes said. “Three-point-five is the historical average, and we were at 3.3% on the 10 year Treasury just six months ago, and over 4 percent on the 30-year. This morning we’re at 2.1% for the 10-year and close to 3% for the 30-year.”

Sun Life’s announcement followed close behind MetLife’s announcement that it would lower the deferral bonus on its GMIB Max variable annuity rider for the second time this year, to 5%, and Deschenes expects many other variable annuity issuers to follow suit.

“My expectation for the next six months, if rates stay at current levels, is that you’ll see additional changes. It’s just a question of when, depending on their particular methodologies, companies will bake the results into their product lines,” he said.

Prudential adjusted last January

Prudential reduced the deferral bonus of its top-selling Highest Daily variable annuity living benefit for the second time at the start of 2011. The move appeared at first to backfire, since it allowed MetLife to come forward with its GMIB Max and seize the lead in variable annuity sales in the second quarter of this year.

But now, with MetLife’s retreat on the rider benefit, Prudential can feel somewhat vindicated. Regarding the richer products that the company sold in the past—including the Highest Daily Lifetime 7, whose deferral bonus doubled the income base in 10 years—Prudential says that the hedges it purchased and the reserves it set aside when those products were sold continue to protect the risks of those products.

“Back in January we made a product change, from Highest Daily Lifetime 6 to Highest Daily Lifetime Income, and we had a marginal fee increase and reduction in the accumulation rate,” said Bryan Pinsky, senior vice president, product development at Prudential Annuities.

Prudential's dynamic asset allocation method, which shifts client money to an investment-grade bond portfolio when equity prices fall, simultaneously reduces its equity market risk and, paradoxically, its interest rate risk, Pinsky said.

"We've done some internal analysis and found that the equity exposure in our product is cut by half or more, and that the overall interest rate exposure is the same or marginally less. Because we have less drag from an equity perspective, we reduce the likelihood that the client's assets are depleted, thereby reducing our interest rate exposure."

First rate cut in four years

Fixed indexed annuity issuers are also feeling the squeeze of low rates. Des Moines-based American Equity Life, which is among the top three issuers of fixed indexed annuities in the U.S., announced to its producers in late September that it would lower caps and participation rates on new sales in the fourth quarter and make its first renewal rate reduction on existing fixed annuities since 2007.

Rates on new sales were reduced by 40 to 50 basis points, as of October 7. The "renewal rate adjustments are intended to reduce the company's aggregate cost of money on policyholder liabilities by approximately 15-25 basis points over the next twelve months," the company said in a release on its website.

But, in a release, American Equity said that it was still able to offer rates that were 1% to 2% higher than the minimum guaranteed rate. State insurance regulators have helped life insurers over the past decade by lower the minimum guaranteed rate to accommodate the drop in prevailing interest rates caused by Federal Reserve policy.

American Equity's move came as no surprise to Jack Marrion of St. Louis-based Advantage Compendium Ltd, a consultant to fixed indexed annuity issuers and marketers. "When rates go down, renewal rates go down," Marrion told RIJ. "On the fixed index annuities, the caps and participation rates are based on how much money is available to buy the index link. So if the company is only making three cents off the dollar from their bonds instead of six percent, something has to give.

"Lowering the index participation is the easiest way to adjust, so you should see the caps coming down. But it's a relative business, and as long as returns from the stock market and certificates of deposit are low, fixed indexed annuities will still look relatively better.

"There are three parts to this. You have to cut compensation to someone. You're already seeing cutbacks to the consumer. You're now seeing compensation to the agents getting cut. The last thing you'll see will be cutbacks at the insurer."

A "modified Japan" scenario for life insurers: Moody's

Moody's expects interest rates to increase slowly as the U.S. economy slowly revives, but "a plausible downside scenario would see stagnation and protracted low interest rates" similar to Japan's experience, said an August 19 report from the ratings agency.

- US life insurers are not expected to incur significant near-term losses… [but] low rates over a long period (5+ years) would subject them to substantial losses that could result in **downgrades, some multi-notch**.
- An extended period of low interest rates would lead… to significantly lower investment income… but **higher statutory reserve requirements** and **meaningful DAC write-downs** (on GAAP financials), weakening companies’ profitability, capital adequacy and financial flexibility.
- Most affected would be issuers [of] **fixed-rate immediate and deferred annuities**, universal life and interest sensitive insurance policies with high minimum crediting rates, **variable annuities with lifetime guaranteed income benefits**, long-term care and long-term disability.
- **Few insurers have bought protection against lower interest rates**, either because of the high cost of doing so or because they deem the risk to be remote. Exceptions are the minority of companies that have bought interest rate floors, insurers with interest rate hedging programs for variable annuity lifetime income guarantees, and companies that have locked in interest rates on the investment of future premiums for products such as no-lapse universal life and long-term care.
- Our review of the 2008–10 regulatory cash flow testing filings for a representative group of US life insurers showed that when interest rates declined, insurers saw a material **worsening of reserve margins**, with several companies needing to post additional statutory reserves. As expected, results showed that insurers performed much worse under declining rate scenarios than under increasing scenarios.