Life Insurers, Under Three Microscopes

By Editor Test *Thu, Dec 13, 2012*

"Life insurers have weathered the financial crisis in terms of solvency but not in terms of profitability," said analyst Mary Pat Campbell of Conning Research. Conning, Ernst & Young and Fitch Ratings have all issued new reports or commentaries on the U.S. life insurance sector.

The problems facing the U.S. life insurance industry—low interest rates, falling demand for life insurance, and increased regulation—are the topic of recently published analyses from three different financial services consulting and research firms.

Ernst & Young, Fitch Ratings and Conning Research have all released reports in the last week. The first two are available for download. Conning's 127-page report, which focuses on life insurer investments, is proprietary, but RIJ received a summary.

The reports describe an industry sector that "has somewhat recovered from the credit crisis but [remains] challenged by decreasing yields," as Conning put it. Ernst & Young noted the irony that an industry that normally absorbs risk now finds itself de-risking.

The burden of low interest rates is a common theme of the reports. Ernst & Young says that rates will "inevitably" rise, but makes no prediction about when that might happen. (Yesterday, Federal Reserve Board chairman Ben Bernanke said rates will stay low until at least mid-2015, and won't rise until the U.S. jobless rate falls below 6.5%.)

All three reports also assess, with varying depth, the nature and impact of regulatory turbulence, coming either from Solvency II, Dodd-Frank legislation, the new Consumer Financial Protection Bureau or, at the state level, from the National Association of Insurance Commissioners.

Conning Research

Conning's report focuses on the contents and performance of the investment portfolios of life insurers. According to the Hartford, Conn.-based firm, the industry earned $178.9 billion in gross investment income in 2011, up 3.3% from $172.8 billion in 2010. Since 2008, however, the compound annual growth of GII has been only –0.5%.

"The decrease in GII was driven by lower dividends, coupons, interest, and rents starting in 2008 rather than from a significant slowdown in the growth of invested assets, which grew at an average year-over-year growth rate of 2.3% over the study period," the Conning report said.

"Life insurers have weathered the financial crisis in terms of solvency but not in terms of profitability," Mary Pat Campbell, the Conning analyst who wrote the report, told *RIJ*. "They are now accepting the fact that low interest rates are the new normal. There's a recognition that they will have to deal with this on a longer-term basis."

Campbell added, “To increase yield, life insurers have been increasing exposure to commercial real estate, lengthening the duration of their bond portfolios and looking at lower credit bonds—not junk, but BBBs. In the financial crisis, they went down in credit quality unknowingly. This time they’re taking a calculated risk.”

Fitch Ratings

In its analysis, Fitch suggested that insurers might not be able to withstand low interest rates for another two-and-a-half years. “Fitch expects sustained low interest rates over the next two years will negatively affect earnings growth rates, but will not have a material negative impact on industry capital,” the ratings agency said, but added: “Fitch expects that if interest rates stay low much beyond 2014, the agency’s outlook would likely be revised to Negative based on weakened earnings profile and anticipated negative capital impacts.”

Regarding variable annuities, Fitch expects that the life insurance industry’s large in-force book of VA business (approximately $1.6 trillion) “will continue to be a drag on profitability, and could cause a material hit to industry earnings and statutory capital in an unexpected, but still plausible, severe stress scenario.”

The ratings agency said it “remains concerned about the risk profile of the VA business… Emerging experience is indicating that the industry’s policyholder behavior assumptions have been too aggressive as a number of insurers have increased reserves in 2010−2012 to reflect lower than expected lapse rates.”

Ernst & Young

Doug French at Ernst & Young summarized life insurers’ historic interest rate dilemma in the same terms as Campbell. “Insurers no longer can manage the problem purely as a short-term crisis — it is now a likely long-term operating challenge,” he wrote.

“This is complicated by the limited ability insurers have to reduce interest rate risks for savings and investment-oriented products like deferred annuities. While the product mix and features will continue to shift, lower projected profitability is to be expected.”

In addition to the squeeze from interest rate policy, Ernst & Young noted the potential for tighter regulations, including “sallies against the tax status of death benefits and the accumulation of cash values within life insurance policies and annuities.”

If Congress perceives that life insurance products are aimed mainly at high net worth customers, French wrote, there’s a risk that it “may try to split the difference by means-testing the taxability of these products, reducing the tax positioning that helps propel sales in the high-net-worth sector.”

At the same time, he added, “the pressure for product transparency and simplified pricing is intensifying.” It may generate scrutiny by the new Consumer Financial Protection Bureau of complex insurance products such as variable annuities with living benefit riders.

Echoing Campbell, French wrote, “To obtain greater yield, insurers may need to increase risk-taking in their asset portfolios, understanding they will have to be adequately compensated in yield for taking on the additional risk.” Insurers will try that and many other maneuvers, he observed, “until interest rates levels inevitably rise.”