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Lower-than-expected lapse rates led to VA charges: Moody’s

By Editor Test *Thu, Jul 18, 2013*

“Companies have some flexibility in deciding when to account for a change [in lapse assumptions] and when to take a charge,” said Neil Strauss of Moody's. “It’s a ball that can be kicked down the road. If policies go out-of-the-money, the lapse rates will be less of an issue."

Variable annuity issuers underestimated the number of contract owners of variable annuities with living benefit riders who would surrender or “lapse” their contracts. Some life insurers have lost billions of dollars as a result, according to Moody’s Investors Service.

Moody’s June 24 report, “Unpredictable policyholder behavior challenges US life insurers’ variable annuity business,” refers to the “double trouble” created for VA issuers from the fact that the most expensive policyholders (those with “in-the-money” contracts where the benefit base is larger than the assets) are lapsing at a lower-than-expected rate while more profitable policyholders (those with “out-of-the-money” contracts) are lapsing at a higher than expected rate.

According to Moody’s, annual lapse rates of VAs with living benefits dropped to the 2% to 3% range after the financial crisis, and have remained depressed.

“The impact can be especially costly to insurers, as more benefits will be paid out than priced for, while margins are compressed—at a time when hedging costs are increasingly expensive because of low/volatile equity market returns and low interest rates,” the report said.

Reserve charges of over $1 billion each have been incurred by AXA Equitable Life Insurance Co. and ING US’s life insurance companies. MetLife took a charge of $752 million. John Hancock (IFS A1 stable), Sun Life Assurance Company of Canada (U.S.) and Prudential Insurance Co. of America took lesser charges, according to Moody’s.

Insurers adequately hedged equity market and interest rate risk exposure on their VA contracts, but policyholder behavior risk is virtually impossible to hedge for and can only be transferred through reinsurance, the Moody’s report said. “Hence, a company that has misestimated policyholder behavior may have little choice other than to recognize the adverse experience in its financials.”

Moody’s noted that it is still too early in the product life cycle of VAs with living benefits to predict how policyholders will use their benefits. It is unknown how many contract owners will annuitize their GMIB riders or convert GLWB riders to income streams.

“Policyholder behavior matters more [in variable annuities with lifetime income guarantees] than in a lot of insurance products,” said Neil Strauss, vice president, senior credit officer at Moody’s, who was an author of the report. “Mortality is more predictable because morbidity data is available right now. Here’s there’s a behavioral issue, and the exposure can change with changes in the environment. That makes this unique.”

Moody's isn't necessarily drawing negative conclusions about companies that are taking charges based on changing assumptions about lapse rates, he added. Nor do the changes in lapse rate assumptions constitute a financial emergency in Moody's view.

"Companies have some flexibility in deciding when to account for a change [in lapse assumptions] and when to take a charge," he added. "It's a ball that can be kicked down the road. If policies go out-of-the-money, the lapse rates will be less of an issue. We're not saying that companies have to take a charge now. We're not reducing ratings for companies that haven't taken a charge. We're just raising the issue."

Strauss wasn't sure how the recognized losses might affect a life insurer's future appetite for issuing variable annuities with living benefits. "Companies that have taken a hit might say, 'We're clean and we can approach [the variable annuity business] with a fresh start.' Others may say, 'We learned our lesson and we're never going back.'"

The entire report on the extent and implications of unpredictable VA contract lapse behavior is available for purchase at Moodys.com.