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## Stormy Weather for Life Insurers

By Kerry Pechter    Thu, Apr 9, 2020

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*Life insurers are buffeted by a perfect storm of falling interest rates, falling share prices and falling sales of annuities. But, according to David Paul of ALIRT Insurance Research, the companies are holding up fairly well.*

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Despite the impacts of lower equity prices, the Fed's zero interest rate policy, business disruptions and a hefty amount of triple-B bonds on their balance sheets, life insurance companies are bearing up fairly well during the coronavirus pandemic.

That's the opinion of David Paul, a principal at [ALIRT](#), an insurance research firm that evaluates the credit strength of U.S. life, property & casualty and health insurers for a client base that include insurance product distributors, insurers, asset managers, and risk managers.



David Paul

Paul spoke at length with *RIJ* earlier this week. What he calls the U.S. life industry's "decent surplus position" and the Federal Reserve's willingness to support the bond market should help companies weather the current storm even as low interest rates potentially weaken the future profitability or availability of their products.

Below is an edited transcript of the conversation between *RIJ* editor Kerry Pechter and ALIRT's David Paul:

**RIJ:** David, you're used to reviewing the balance sheets of life insurers for strengths and weaknesses. What do you see right now?

**Paul:** As concerns their balance sheets, the more asset leverage a company has—which is an expression of surplus to general account invested assets—the greater the stress that can occur in a downturn like this. Overall, the U.S. life industry has asset leverage of just south of 12%. So it's fairly leveraged. But that's one of the best ratios in 20 years. And, given the long-term nature of their liabilities, this type of leverage is normal.

**RIJ:** These surpluses—are they related to a company's reserves?

**Paul:** I heard a recent news report that the industry has plenty of "reserves." But when one talks about reserves, in our world this is really a liability term. Surplus is different. As the difference between assets and liabilities, surplus is the financial cushion that's available to offset investment losses or strengthen existing reserves, if needed.

Let's say an insurance company sold variable annuities with rich lifetime income guarantees. It may have to put up more reserves if those guarantees go "into the money." Or, if mortality trends and/or projected investment returns weaken, reserves would have to be strengthened for the products sold. The surpluses, which are hopefully being constantly bolstered by operating earnings, are there to provide any needed strengthening of existing reserves.

**RIJ:** And where do earnings fit into that picture?

**Paul:** Imagine a situation where the reserves are fine [i.e., sufficient] and the investments are fine [i.e., not impaired]. In that case, the earnings will become extra funds that go into surplus. The U.S. life insurance industry today is generally profitable. It has had a nice run. It's in a relatively good balance sheet position. And, as a result, its surplus has been built up.

**RIJ:** Life insurers, like other investors, have been searching for yield by taking more risk and buying more BBB-rated bonds, which are the lowest-rated investment-grade fixed income instruments, than they traditionally have. In a credit crisis, will those holdings come back to haunt them?

**Paul:** The aggregate amount of BBB-rated bonds held by U.S.-based life insurers has exploded over the past few years. But, as I mentioned, the industry's surplus has also grown nicely over the last decade. So the industry's leverage to these bonds is not out of whack.

For instance, the 10-year average ratio of BBB bonds to industry surplus is 195%; at year-end 2019 it was 199%.

Outside of all bonds, the industry's second largest investment class would be commercial mortgage loans, which were roughly 13% of the industry's invested assets at the end of 2019. In both cases, the industry is entering into this type of environment in a better position leverage-wise than during the last crisis.

What's unique about this crisis, in terms of potentially mitigating impacts to the asset side of the life insurance industry's balance sheet, is that the government has pledged to build, rapidly, what we call a "liquidity bridge" over the crisis. Massive government monetary and fiscal intervention will hopefully help to minimize economic damage from the current crisis, which could otherwise produce sizeable investment losses. We hope that this economic crisis will be temporary, whatever that means.

**RIJ:** But what if this financial crisis gets worse?

**Paul:** If those bonds are downgraded to below investment grade, the amount of risk-based capital that insurance companies are required to hold against those securities will ramp up quickly. If the ratings go to double-B or triple-C, the capital requirements jump. That's a reality that insurers may have to deal with. We call those bonds "fallen angels." The reported value of bonds under statutory accounting does not change with interest rate movements, because companies don't have to mark them to market as they do under GAAP [General Accepted Accounting Principles]. If they hold the downgraded bond to maturity, and it doesn't default, then it won't affect the balance sheet. You certainly wish in the current stressed environment that the insurance carriers weren't so loaded up with triple-Bs, but they needed more investment spread over the past decade as portfolio yields came under pressure. Otherwise their products would have been much less attractive.

**RIJ:** On the plus side, some bonds must be bargains right now.

**Paul:** When we think of low rates, we're used to thinking of the 10-year Treasury, now with a yield of 0.6%, as a proxy for overall bond yields. But the relative credit spread on corporate fixed income and other non-government debt has actually expanded recently. People were fearful and sold off bonds. We've heard life executives say that their portfolio yield will actually improve if they can buy these bonds at depressed prices. Ironically, if you're willing to buy triple-Bs now, and you think you minimize excessive exposure to credit losses, you can get more yield and potentially make your products more attractive.

**RIJ:** OK, we've touched on the asset side of the balance sheet. What's happening on the liability side?

**Paul:** On the liability side of the balance sheet, it's possible that reserve liabilities will need to be strengthened during a financial crisis. The math is simple: If liabilities go up, the surplus goes down. If you're looking at where liabilities might be hit, here's an example. When companies are pricing products, whether it's life insurance, disability, or long-term care insurance—any of these long-tail products—they base that pricing in part on what they think their investment returns will be over time.

As the yields on all types of investments decline, the carriers have to recalibrate how much investment income they think they'll earn in the future. If that number goes down, they may have to build up existing reserves to reflect that. And this will pressure surplus. Or when the lifetime income guarantees on variable annuities go "into the money," the liabilities may go up. That also puts pressure on surplus positions.

**RIJ:** So, if I understand it correctly, the surplus can be threatened if, for whatever reason, the assets lose value or the liabilities get bigger.

**Paul:** Yes, both sides of the balance sheet can be hit. That's where the pressure comes from. The problems are traditionally more on the asset side. But the Federal Reserve is throwing its full weight at that current problem, and companies that might otherwise quickly get caught in a liquidity crunch will hopefully not be. Afterwards, if the equity markets or investment yields improve, we'll see existing reserves potentially "taken down," which will help surplus positions.

**RIJ:** We're also seeing a sales drop in annuity products. That has to hurt too.

**Paul:** We'll definitely see a revenue hit. With social distancing, it's tough to distribute products when you can't physically get in front of people. It's also more challenging to sell products to people in an environment where they're pulling in their horns and hoarding cash. Two weeks ago, even Treasuries were being sold.

On the other hand, a good annuity or life insurance salesman will tell clients, "This crisis is an example of why you need guarantees." Whole life insurance has no equity market risk, it pays a dividend, and it builds up cash value that you can use at times like this. People are getting the message. One distributor said that people who were jumping out of variable annuity contracts a couple of weeks ago are now telling their advisers that they want to get back into them. That's the kind of behavior you see in a panic.

**RIJ:** Any other potential points of pain?

**Paul:** There will be losses. Disability claims will tick up; people who lose their jobs will decide to claim disability benefits. Companies are generally still paying their salaries; they don't want to lose talent, so revenue is down but expenses remain. So you'll see lower income or operating losses. Operating losses, all things equal, will depress surplus positions. This crisis wasn't driven by a recession, so if we can get through the current health crisis in a relatively rapid manner—a big if—it doesn't have to create long-term economic havoc.

**RIJ:** Even though equity indexes have rebounded from their recent lows, life insurance holding company stocks are still far below their recent peaks. Is that a source of concern for you or your clients?

**Paul:** ALIRT doesn't react to the stock prices of holding companies. As we remind our clients, insureds are not legally exposed to the holding company but rather to the legal entity that actually underwrites their policies. And these legal-entity insurers are closely regulated by state insurance departments. In this stressed environment, state regulators will make sure that life insurers aren't paying out excessive amounts of money to holding companies, as their primary concern is the solvency of these insurers.

But when the holding companies are impacted and they're putting out fires, they can become distracted. The idea of pulling in horns becomes likelier. If the parent feels that the investment community doesn't like the risks it is underwriting, its life insurer subsidiaries might become more conservative in the types of policies they issue.

**RIJ:** Publicly traded companies in this industry have bought back billions of dollars worth of their own shares in recent years. That might make Wall Street analysts and shareholders happy, but it worries some consumer advocates. Some of the money for buybacks comes out of the life insurance subsidiaries, I would guess.

**Paul:** We watch the amount of dividends paid out by insurance companies, especially to publicly traded parents. If holding companies become more leveraged over time—that is, they take on more debt—their life insurer subsidiaries may be called on to pay more dividends to the parent to support that debt. This can serve to constrain an insurer's surplus position, potentially making it more leveraged versus its peers.

Certain life insurers have also been paying out money to their publicly traded parents—not because those parent necessarily needs money to service debt payments, but because

they're buying back their stock and/or paying out dividends to shareholders. Whatever the reason, surplus funds that are up-streamed to parent organizations can cause an insurer to become more leveraged and therefore potentially more financially constrained.

**RIJ:** Excuse my naïveté, but are you saying that the parents might be issuing debt even as the life insurance subsidiary is buying debt?

**Paul:** For a company to ramp up a new product, it has to hire actuarial talent and managerial talent, pay commissions to producers, and pay for the infrastructure required to produce and service the product. And if you're a CEO, and you have a lot of stock options, and you feel a fiduciary duty to your shareholders, you'll want to help the stock price. It's in the nature of a public company to do that.

**RIJ:** Even though large life insurance companies rarely go bankrupt, consumers who buy their annuities and other long-dated products often worry about that happening. If we go into a sustained recession, will the potential for failure increase?

**Paul:** It's really hard to put a life company out of business because it's hard for them to experience a "run on the bank." There's a real stickiness to life insurance products. Life and disability and long-term care products tend to be held for a long time. Even with shorter-tail annuity products you have surrender charges that serve to protect the insurer.

To have an *[It's a Wonderful Life](#)*-style run on the an insurance company, a lot of individuals would have to decide to get out of products at the same time, which is unrealistic. So, to answer your question, we don't look at this crisis as provoking a liquidity crunch that turns into a balance sheet issue. At this point, it's really an income statement/cash flow issue. Insurance companies may have several quarters of operating losses, but this should not necessarily threaten their balance sheets. If this crisis is short term, it shouldn't turn into that at all.

RIJ: Thank you, David

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