

# **The Impact of the Current Financial Crisis on the Life Insurance Industry**

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### **Insight from Nease, Lagana, Eden & Culley, Inc. – Atlanta, GA**

When the current financial crisis first emerged in September 2008, we produced a white paper addressing its potential impact on life insurance carriers and policyholders. After almost 6 months, the crisis has deepened and is impacting virtually all industries. As such, we wanted to update our paper with current information. If you read our October 2008 paper, you will recognize the first several paragraphs which explain many important qualities unique to life insurance carriers and policyholders. The remainder of the paper addresses the current financial state of the industry.

With the stock prices of major life carriers down dramatically, it is clear that fear and an overall lack of confidence in our financial markets are ruling each trading day. Policyholders are understandably concerned by recent events. It is natural to think if a life insurer's stock price has dropped 50%, or more, that the contract you hold may be in jeopardy. However, it is important to distinguish between the interests of stockholders and policyholders.

Stockholders are focused on the future earnings of insurance companies. Price declines across life insurance stocks reflect that the markets expect higher capital costs and declining investment portfolio returns to erode the earnings that shareholders may have expected. A declining stock price does not directly impact the operations of the company with respect to policyholders; however, it does indirectly impact the amount and cost of capital that a company could raise should the need arise.

Policyholders are focused on solvency: a life insurer's ability to honor the contract in place and pay a claim if submitted. Again, a declining stock price does not directly impact a carrier's solvency. In fact, there are a number of safeguards (noted below) that may provide policyholders meaningful comfort in volatile times. To look at it a bit differently, when you buy insurance you are not buying the stock of the insurance company. Instead, you are purchasing an asset that is subject to strict regulations designed to protect policyholders.

Conservative Reserves and Capital: Life insurers are required to hold reserves, within the regulated insurance subsidiary, to cover the cost of all future claims. The required reserves are calculated using a conservative method mandated by state law and regulation. In addition to conservative reserves, life insurers are also required by state law and regulation to hold a capital and surplus cushion. The size of this cushion is based on the types of investment risk in the insurer's portfolio: the insurance risk the insurer is underwriting, the interest rate risk the insurer is exposed to, and the general business risk. If the capital and surplus of a company falls below a minimum required level, regulators are required to intervene and take specific action to protect policyholders.

High Quality General Account Assets: Since life insurers are required to hold additional capital and surplus for investments made in riskier assets, most insurance portfolios are comprised of the highest quality assets. These portfolios typically consist of a well diversified mix of high quality bonds, commercial mortgages, and real estate. Additionally, life insurance company portfolios have much less leverage than banks or investment banks, which provides less portfolio volatility. Liquidity is also an important aspect of a life insurance company's portfolio. As part of their regulatory filings, life insurers are required to evaluate thousands of economic scenarios to ensure that the assets they hold will provide sufficient liquidity to meet policyholder liabilities under a wide range of economic circumstances. Therefore, even if the investments noted above (high quality bonds, commercial mortgages, and real estate) are adversely impacted by a market downturn, there is comfort that sufficient liquidity exists to meet policyholder liabilities.

Separate Account Assets: For variable products, premiums invested in the separate account funds are segregated from the insurer's general portfolio. Generally speaking, state law protects separate account assets for the policyholders of the separate account. This provides an extra layer of protection for policyholders that are significant during times of broader financial instability. Since separate account assets are not comingled with the insurer's portfolio, creditors of the insurance company do not have claim to these assets.

### Regulated Life Insurance Subsidiaries Have Protections In Place To Protect Policyholder Interests:

Insurance regulations provide protections that essentially create a wall between a life insurance subsidiary and the parent company (and other affiliated subsidiaries). These regulations require that all assets, reserves, capital, and surplus must be held separately by the life insurance subsidiary. In addition, any transfer of capital or surplus to the parent company (or other affiliated subsidiaries) must be approved by regulators. Before approving such transactions, regulators are required to confirm that the transaction would not in any way impair the life insurance company's ability to pay policyholder benefits.

The primary purpose of regulations is to protect policyholders and their beneficiaries. Historically, the life insurance industry has always paid death claims in the case of a carrier insolvency and has worked with state regulators to develop an association of guarantee funds to provide a minimum floor for benefits. It should be noted that some current insurance product types, specifically no-lapse guaranteed policies, have not been subject to a major insolvency event. However, it has been the practice of the industry to ensure that death claims are paid appropriately.

### ***Despite Regulatory Safeguards, Fear Remains***

There is lingering concern, however, regarding the impact of the broader market declines on life insurance investment portfolios, as well as the liquidity of the assets in these portfolios. Douglas L. Meyer, an insurance analyst at Fitch Ratings, commented: "Insurance companies tend to focus on high-quality investments." When the declines were mainly in the lower-quality investments, he said, the industry was relatively sheltered from harm. Now, though, "the depths of the current credit crunch are starting to affect the high-grade securities, so that's starting to affect the insurance companies more."

With the release of fourth quarter financials, stress on life insurance company capitalization levels is increasing. This stress appears to be greater for large writers of variable annuity products with guaranteed living benefits. Although insurers' investment portfolios are generally conservative, they have not been immune from the current economy. Insurers invest a significant percentage of their portfolio in fixed-income securities including government bonds, corporate bonds, mortgage-backed securities, and mortgages. Although these sectors generally have not experienced losses tantamount to the equity markets, values are considerably depressed. Mortgages and mortgage-backed securities are receiving the most scrutiny as the possibility exists that the ongoing recession will continue to negatively impact these investments. With continued pressure on capital levels, rating agencies have put the life insurance industry on a negative outlook and have signaled that downward rating actions are expected. In fact, a number of major life carriers have been downgraded over the last 2 months. These announcements and downgrades are reflective of the uncertain direction of the current crisis.

On February 26, S&P lowered the financial strength of 10 carriers including well-known companies such as Hartford, Lincoln National, MetLife, Pacific Life, and Prudential. The downgrades were a result of S&P applying new criteria which specifically addresses carriers' bond holdings, commercial mortgages, and commercial mortgage-backed securities (CMBS). S&P noted that "given these difficult economic conditions, we believe that life insurers' bond holdings, commercial mortgages, and commercial mortgage-backed securities (CMBS) could experience unprecedented stress in the next 12 – 18 months." Historically commercial mortgages have been immune from minor economic slowdowns and to date have not suffered as much as residential mortgages; however, the continued sluggish economy poses a threat to these traditionally lower-risk investments. While acknowledging these issues were reasons for the downgrades, S&P did note that "although...ratings actions reflect our opinion of a general decline in the overall creditworthiness of the U.S. life insurance sector, we continue to believe the credit fundamentals of the life insurance industry are strong."

Life insurers also have another valuable investment variable on their side—time. Insurance policies are priced on sound actuarial assumptions and are considered long-term contracts. This unique combination provides an advantage to insurers when implementing their investment allocations. S&P believes "that strong liquidity and an insurer's willingness and ability to hold portfolio investments to maturity should provide the necessary bridge for insurers to get beyond the current distressed fixed-income markets."

## ***Recent Industry Developments***

**Guaranteed Life Products:** The current pricing for No Lapse Guarantee Universal Life policies is under pressure. Two factors drive a significant portion of the cost of No Lapse Guarantee UL products (NLG): the cost of capital and the carrier's assumption about future investment returns.

First, almost all carriers rely on capital solutions to fund the reserve costs of long term guarantees. Most carrier capital solutions are based on some type of financing. As a result, the cost of these solutions is directly tied to the carrier's financing costs. Because carrier financing costs have significantly increased over the last six months, the capital solution costs have also increased. To offset these higher costs, carriers have three possible actions:

- Raising prices, to recover the increased cost of capital
- Reducing the length of the guarantee to reduce the reserve costs
- Withdrawing from the market until better (or some) financing becomes available

The second major factor driving the cost of No Lapse Guarantee UL policies is future investment returns. In the past, carriers have typically assumed that over the life of the policy their investment yield will gradually increase to some higher long-term average, as opposed to the relatively low level that we have experienced in the recent past. As we continue to see downward pressure on interest rates, carriers are re-evaluating their long-term investment yield assumptions. A lower assumption in the projected earnings rate increases the guaranteed premiums.

Over the past several months, we have witnessed carriers both withdraw from this market and/or increase premiums. We expect this trend to continue at least until the economy appears to be in prolonged positive trend. It should be noted that increases in the cost of capital or reductions in the future investment returns are putting upward price pressure only on **new** issues of guaranteed policies. Policies already issued with guaranteed premiums cannot have those premiums increased or the guaranteed features modified. The risks described above are assumed by the insurance company and the risk to the existing policyholder is solvency—not premium increases.

**Annuity Products:** Variable annuities with guaranteed living benefits are the most impactful product line experiencing significant pricing issues due to the recent decline in the equity markets. These annuities offer policyholders the opportunity to invest premiums in a variety of funds and also provide guaranteed minimum withdrawals often for the life of the insured, independent of the return of the underlying funds. These products expose the carrier to two major risks:

- Equity risk – the risk that the underlying funds underperform relative to the guaranteed minimum withdrawal guarantee
- Longevity risk – the risk that the insureds outlive the ability of the underlying funds to provide the withdrawals for the life of the insured

Most carriers offering variable annuities with guaranteed living benefits use hedging programs to protect themselves from market declines. Because the cost of these hedging programs has increased, variable annuity carriers are faced with the decision of whether to, for newly issued policies, increase the price of guaranteed living benefits or change the terms of the guarantees. Additionally, some carriers may decide to withdraw from the market altogether.

**Regulatory Action:** On January 29, the Executive Committee of the National Association of Insurance Commissioners (NAIC) denied the insurance industry's consideration to relax capital and surplus requirements. In a statement following the decision, NAIC President and New Hampshire Insurance Commissioner Roger Sevigny commented: "So far the insurance industry is in much better condition than most of the rest of the financial services sector because of strong state solvency regulations. Simply put, the industry has not made a credible case for why we need to make changes on an emergency basis, and why those changes should be limited to the specific proposals made by the industry."

### ***AIG: Problems Not from Insurance Subsidiary***

It is important for life policyholders to remember that the AIG situation does not involve an impairment of the life insurance operations. AIG's troubles stem from a non-insurance entity, AIG's Financial Products subsidiary that was issuing credit protection products. These products have suffered huge losses due to the current credit crisis. These are losses of shareholder value, not policyholder value. The assets within AIG's life subsidiary are protected by regulation for the benefit of the life subsidiary and appear to be sufficient to meet the life subsidiary's liabilities.

On March 2, AIG reported a net loss of \$61.7 billion. Concurrently, the federal government announced additional support for the continued restructuring of the company. The existing terms of the U.S. Treasury's preferred investment were modified and an additional \$30 billion equity capital facility was established. The goal of modifying the existing facility and creating the additional \$30 billion facility was to allow AIG to proceed with the divestiture and/or recapitalization of its subsidiaries. At this time, AIG is actively seeking purchasers for its life insurance subsidiaries and it's likely that policyholders will end up with a strong, highly rated carrier.

### ***A Look Ahead***

These are unprecedented times and because things can change at any moment nobody can accurately predict what may be next. Our Firm continues to monitor developments and engage carriers in conversations, as we continue to serve the needs of clients.

While uncertainty persists, we believe life insurance may offer a safer port in the current financial storm. The policyholder safeguards noted above, together with products offered by highly rated, financially strong carriers, can create—under the appropriate circumstances—an attractive opportunity when compared to many other financial alternatives.