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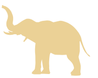

The Elephant in the Room

The Impact of Prolonged Low Rates for the US Life Industry

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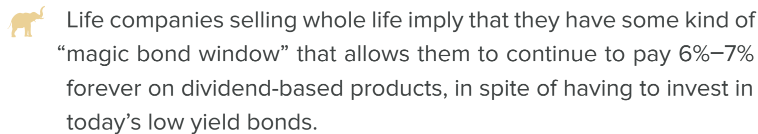
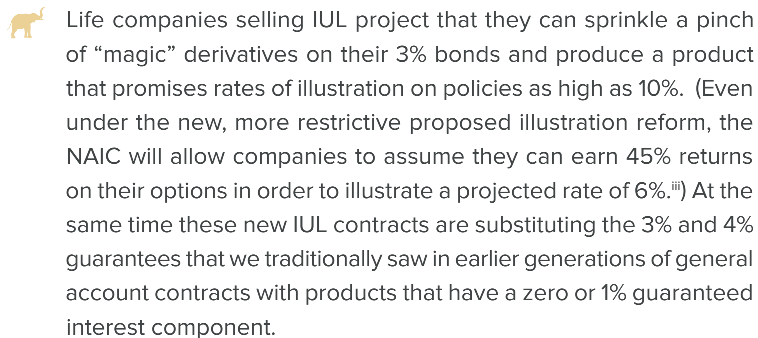
The metaphor of "not talking about the elephant in the room" is a phrase often used to describe when people avoid directly discussing the real issue that is at the center of what seems like multiple peripherally-related issues. If there really were an elephant in the room, we might observe that the room is crowded, has taken on a bad odor or that large piles of noxious debris seem to be accumulating in the room. For the US life industry, the elephant in the room is a period of prolonged low interest rates and the impact these low rates have on every element of the US life business. For approximately the last three years, I have been blogging about a series of serious issues that face the US life industry ranging from wholesale changes in the products we sell, illustration reform addressing abuses of Index Universal Life, manipulation of insurance company reserves through financial engineering (primarily through captive reinsurance transactions) and the long-term implications of private equity taking over 22 US life companies. All of these issues directly or indirectly tie back to bond yields at or below 3% and their impact on traditional margins and spreads that insurance companies make on the products they sell.

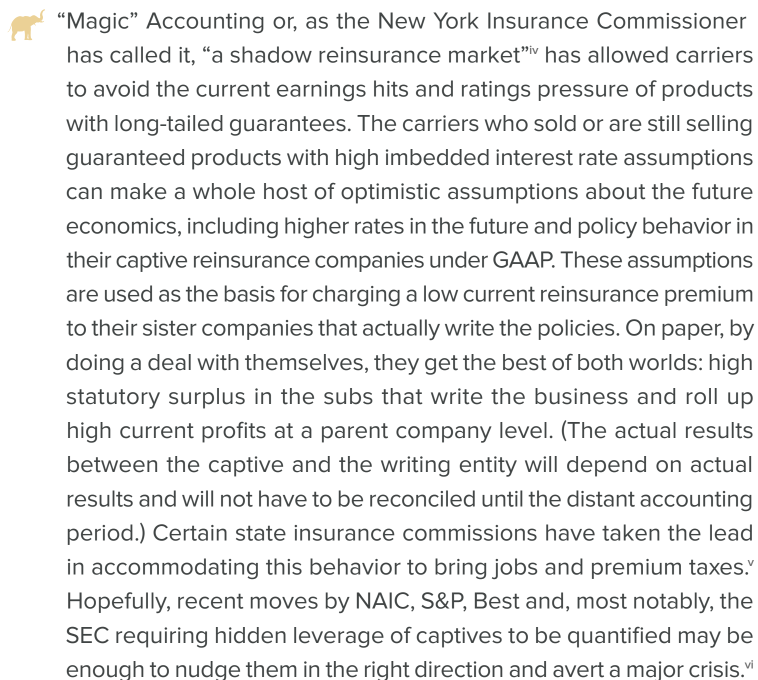
Furthermore, a recent Moody's report[i] acknowledged that low rates are likely to continue for the foreseeable future, this condition of persistent low rates is not unique to the US and, in fact, the Japanese life industry was forced to deal with a similar set of circumstances 10 years ago when these spreads went negative. Japanese bond yields declined ahead of those in the US and remain persistently low. As a result, Japanese life companies saw massive loss of capital through the resulting disintermediation of existing promises to policyholders and low yields. Six of its 15 largest life insurance companies were forced into a national rehabilitation plan to deal with the issue.[ii] In the face of this current reality in the US and the experience in Japan, it appears that many of those in leadership of the US companies and the state insurance regulators refuse to publicly acknowledge, let alone deal decisively with, the issues this causes. The reluctance to change the status quo might be for several reasons: perhaps it would send share prices down for US insurance stocks, accelerate rating downgrades or, perhaps, it may force fundamental change in how the industry is structured, including questioning the whole premise of state insurance regulation. But each of those reasons for inaction does not get rid of the elephant. In a discussion with one of our most prescient, seasoned, veteran producers, he summed up the behavior by simply saying, "All insurance companies lie, they just tell different kinds of lies." Here is how I interpret his statement in light of current issues:



Life companies selling whole life imply that they have some kind of "magic bond window" that allows them to continue to pay 6%–7% forever on dividend-based products, in spite of having to invest in today's low yield bonds.



Life companies selling IUL project that they can sprinkle a pinch of "magic" derivatives on their 3% bonds and produce a product that promises rates of illustration on policies as high as 10%. (Even under the new, more restrictive proposed illustration reform, the NAIC will allow companies to assume they can earn 45% returns on their options in order to illustrate a projected rate of 6%.[iii]) At the same time these new IUL contracts are substituting the 3% and 4% guarantees that we traditionally saw in earlier generations of general account contracts with products that have a zero or 1% guaranteed interest component.



"Magic" Accounting or, as the New York Insurance Commissioner has called it, "a shadow reinsurance market"[iv] has allowed carriers to avoid the current earnings hits and ratings pressure of products with long-tailed guarantees. The carriers who sold or are still selling guaranteed products with high imbedded interest rate assumptions can make a whole host of optimistic assumptions about the future economics, including higher rates in the future and policy behavior in their captive reinsurance companies under GAAP. These assumptions are used as the basis for charging a low current reinsurance premium to their sister companies that actually write the policies. On paper, by doing a deal with themselves, they get the best of both worlds: high statutory surplus in the subs that write the business and roll up high current profits at a parent company level. (The actual results between the captive and the writing entity will depend on actual results and will not have to be reconciled until the distant accounting period.) Certain state insurance commissions have taken the lead in accommodating this behavior to bring jobs and premium taxes.[v] Hopefully, recent moves by NAIC, S&P, Best and, most notably, the SEC requiring hidden leverage of captives to be quantified may be enough to nudge them in the right direction and avert a major crisis.[vi]

Finally, private equity firms have brought their own "Wall Street financial magic" to the life industry, attempting to turn blocks of unprofitable low interest rate policies into super-charged investments with returns of 15 to 20% return on equity for their investors. They use the same "magic accounting" of captives but with even greater leverage and out of the view of pesky SEC reporting. Their plans not only involve leverage of the liability side, but to goose up the balance sheet by making more aggressive investments in their general account. The vast majority of transactions involving US life insurance companies since the financial crisis have been to these groups.

"All progress begins with telling the truth."

At the end of the day the basic question remains, "how does an insurance company buy a 3% bond, paying all the first year premium in the form of loads and commissions, and create a cash value life contract that both allows the company to make a profit and still provide consumer value?" Perhaps the answer is that they cannot, at least not on the terms promised to the consumer. All of the above mentioned "gimmicks" or "lies" dodge this basic question.

For life insurance professionals, these circumstances call to question, how do they advise clients in a professional and ethical manner? Ignoring them is neither ethical nor professional. There is a good chance that these issues may address themselves, if rates may recover soon and gradually enough. Alternatively, perhaps a whole series of regulatory reforms and moves by the rating agencies aimed at addressing symptoms of these problems might be effective.[vii] But for thoughtful insurance professionals who really want to objectively advise and protect clients, it must start by admitting low rates are the elephant in the room. As Dan Sullivan says, "All progress begins with telling the truth." This paper is not an in depth attempt to address the technical issues involved with these challenges but instead it is a call to action. We see it as part of a strategic dialogue around all of the resources and tools that we have assembled as part of Life Assurance 360 to equip you to help clients make the right decisions for the long term.

There are Four Key Strategies:

1 Insurance Professionals must be much more selective of which companies to recommend: We believe there will continue to be a shaking out of the US life industry. Both a combination of rating adjustments and more sales of unprofitable life companies to private equity create new and greater risks for policyholders. ValMark has created a whole series of resources and tools to help our member firms create their own "select list" of those insurance companies with whom they have purposely chosen to work. Much of the data comes from our STAR Ranking™ system which we started building in 2008 for evaluating carriers, and we will take another large step forward with the introduction of our Carrier Select Tool.

2 Start with reasonable economic assumptions in product projections: The most persistent error that our industry has made over the last 20 years is giving in to the temptation to over promise the benefits of the policy and ignore the non-guaranteed elements. L.S. Rybka first wrote about this 25 years ago with his best-selling article "The Ledger Lie." Life and annuity products must ultimately reflect returns on underlying investments less expenses and profits. Projections of any kind are just that, and the best insurance professionals have always modeled alternatives. ValMark's industry-leading Life Assurance 360™ and CARES Process™ tools help our member firms do this in a way that brings objectivity to this process and helps clients make more informed choices.

3 Consider Diversification: Whenever a client is relying on a single insurance contract for a significant part of their retirement or estate plan, consider diversifying this coverage among quality carriers. This caveat is even more important when the products are general account products. In writing this article, I pulled out ValMark's first version of its Life Insurance Design Questionnaire® from 1995 and it included a list of major life companies. Twenty years later two-thirds of the names on the list are no longer stand-alone entities and many saw significant downgrades.

4 Apply the fundamental principles of asset allocation to insurance. It doesn't make sense to recommend that a client allocate a significant portion of their net worth to 10 and 15 year bonds in this rate environment, perhaps it doesn't make sense to buy an insurance product that has to lock in these same bonds. The fundamental value proposition of separate account life and annuity products bracketed by contractual guarantees that offer favorable features and taxation may offer a much more compelling long-term value proposition for policyholders. Besides providing transparency and greater potential for appreciation, the separate accounts give clients the best independent protection from purposeful or inept carrier behavior.

[i] "Low Interest Rates are Credit Negative for Insurers Globally, but Risks Vary by Country." Moody's Investors Service, March 26, 2015.

[ii] "No Policy is the Best Policy." The Economist, November 28, 2002.

[iii] Proposed NAIC: Actuarial Guideline YY, April 16, 2015.

Joseph M. Belth, "No. 69: Indexed Universal Life – Debate over Sales Illustrations." September 30, 2014.

[iv] Benjamin M. Lawsky, "Shining a Light on Shadow Insurance: A Little-known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk." NY State Department of Financial Services, June 2013.

[v] Joseph M. Belth, "No. 73: Iowa and Nebraska – More on Frightening Accounting Rules." November 19, 2014. Joseph M. Belth, "No. 71: Iowa's Frightening Insurance Accounting Rules." November 6, 2014.

[vi] "Methodology: Treatment Of U.S. Life Insurance Reserves And Reserve Financing Transactions", S&P Rating. March 12, 1015. www.globalcreditportal.com/ratingsdirect/

[vii] Kris DeFrain, "Expected Changes to Insurance Regulation for Captives and Special Purpose Vehicles." CIPR Newsletter, July, 2014.

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Lawrence R. Hamilton et al, "NAIC Adopts Guidance on Acquisition of Control of US Insurers." Mayer Brown Legal Update, April 23, 2015.