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## TRACKING THE NUMBERS

*Outside Audit*

# Life Insurers Face a Profit Squeeze

### Cost of Policy Guarantees On Some Business Lines May Be Underestimated



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Life insurers have put a lot of bells and whistles on their products in recent years. Great for policyholders. Maybe not so good for the insurers and their shareholders.

The problem: A competitive frenzy led insurers to offer generous guarantees on some business lines, but insurers may well have underestimated the costs of those guarantees.

In particular, industry executives and analysts say, many insurers face a profit squeeze from variable annuities and universal-life insurance policies they sold. In the case of variable annuities -- a $129 billion market last year -- the guarantees protect the consumer against losses on the investment portion, while those on policies in the $4 billion-a-year universal-life market essentially promise that the policy will stay in force at specified premium rates and the death benefit won't shrink, even if costs rise for the insurer.

**ANNUITY ANGST, LIFE LET DOWNS?**

See charts[0] of annual insurance sales by product.

The insurers provided such guarantees to make the companies more competitive in a crowded marketplace. But, because some aspects of the guarantees are relatively new twists, the insurers had no track record to draw on when pricing them or setting up reserves to meet future claims. Now costs are becoming clearer.

The profit hit could prompt insurers to raise prices or trim back the guarantees on these products going forward. But, as for the billions of dollars of such products already sold, the higher costs could pinch profit margins and force insurers to increase their reserves. Meantime, even the industry's trusted standby, term life, could prove costly in coming months and years.

Often called "no-lapse guarantee" policies, or sometimes "term for life," the guaranteed universal-life policies provide both a death benefit and a savings account. Unlike other kinds of life insurance, premiums can't be changed.

Such policies are all the rage among life-insurance agents. Agents say they are busy replacing existing policies -- particularly among older policyholders -- with the new, guaranteed ones. But concerns are mounting that insurers' current reserves are based on unrealistic assumptions about investment returns or about "lapses" -- policies that expire unpaid, usually because holders stopped paying premiums.

Indeed, Peter Katt, a fee-only life-insurance adviser in Mattawan, Mich., says many insurers seem to be counting on unusually high numbers of "lapses."

Moody's Investors Service warns that the implications of any pricing problems or erroneous lapse-rate assumptions "will become apparent sometime during the next five to 10 years" without changes by insurers. Even a one percentage-point error in assumed lapse rates, Moody's notes, "can have a material impact on product profitability."

A growing "life settlement" market -- where third-party, professional investors buy policies from ill or elderly holders -- may mean fewer lapses are likely, Moody's points out.

Life insurers acknowledge the downside, if in fact the assumptions underlying the policies are incorrect. "There's a risk for the companies here," says Paul Graham, chief actuary for the American Council of Life Insurers, an industry trade group. "If investment returns do not allow them to collect that much money, then they have to take it out of their back pocket."

A spokesman for one insurer, **Prudential Financial** Inc., notes that the company prices a variety of products to generate profits in concert, meaning losses for one line won't spell disaster.

In contrast, variable annuities offer an investment account wrapped in insurance; the money is typically invested in mutual-fund-like accounts. Sales of these complex products fell sharply from lofty highs with the stock market. In an effort to lure buyers, annuity sellers have been guaranteeing that customers won't lose money on their initial investment, even if the mutual-fund-like investments perform poorly.

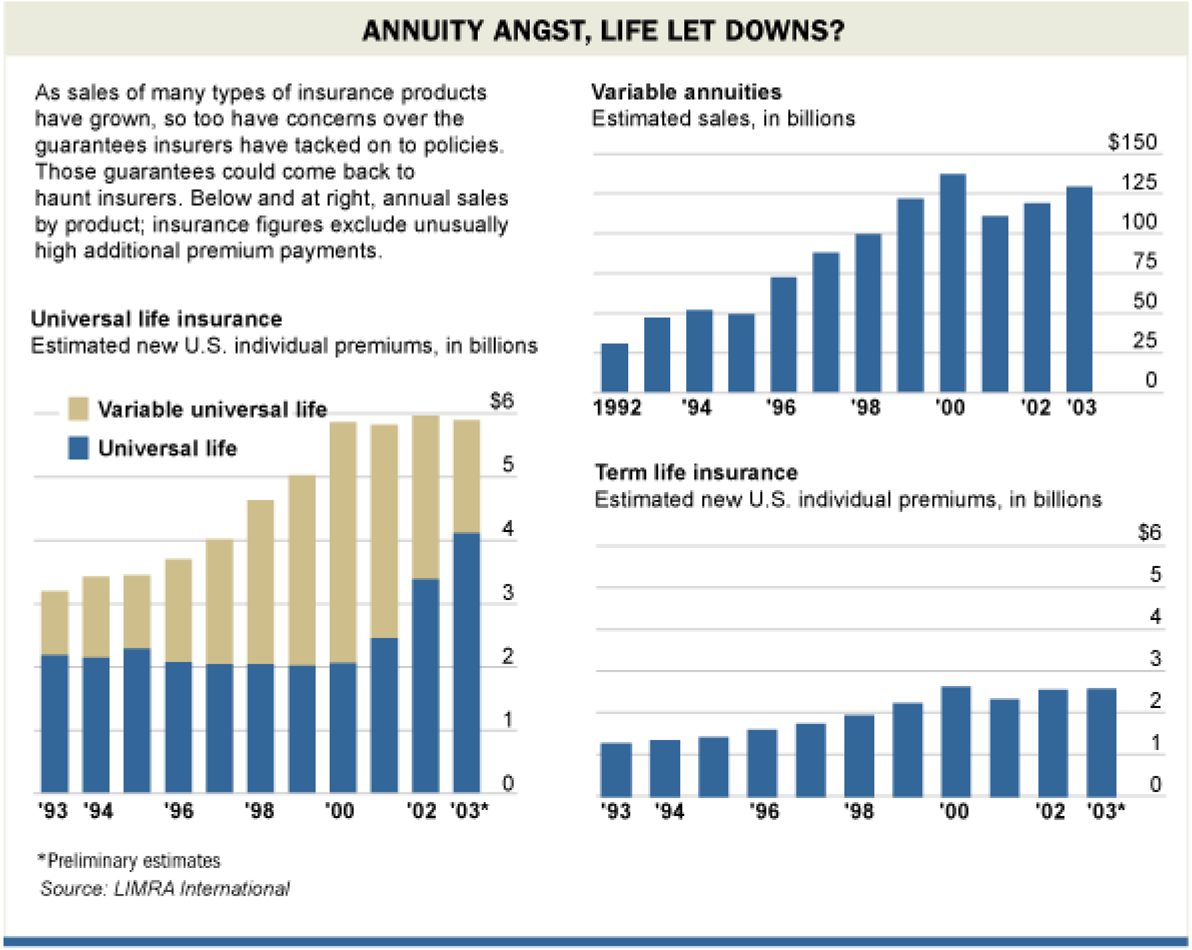
Now regulators are wrestling with how much insurers must set aside to reserve for such guarantees.

Existing rules "don't reflect the true risk of variable annuities with guarantees," says Eric Berg, an insurance-stock analyst with Lehman Brothers.

The pricing models originally used by annuity writers were flawed, but newer models are considerably more accurate, says Mr. Graham, the trade-group actuary. "Those guarantees were mispriced by several large companies," he says. "We're at the point where people have learned from their mistakes."

Issues with the annuities and universal-life insurance arise even as costs also are rising for the insurers with plain-vanilla term-life insurance, one of the simplest insurance products sold. Term-life prices have been falling for years, thanks to insurers being able to offset reserve requirements by selling on some risk to so-called reinsurers. But reinsurers are now raising the rates they charge insurers, thanks to higher costs of their own.

While insurers have some alternatives for reducing the cost of this reinsurance, ultimately they may face a tough choice: Keep rates low while expenses rise, cutting into profits, or pass the increased costs along to customers and risk losing business to rivals. Indeed, some insurers are already raising term rates.

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