Special Comment

December 2003

Contact	Phone
New York	
Robert Riegel	1.212.553.1653
Laura Levenstein	

Moody's Views on Current Conditions in the US Life Insurance Industry

Summary Opinion

Moody's has maintained a negative outlook on the US life insurance industry and on several individual life insurance companies since the third quarter of 2002. Over the past 18 months, we have downgraded the ratings or changed the outlook on about 25% of our 75 rated life insurance groups.

The primary drivers of our negative outlook for the industry were the investment losses, equity market declines, and low interest rates that had resulted in weakened earnings capacity and declining capital adequacy for many US life insurers. The environment for life insurers has improved and a stable outlook for the industry could result if these positive trends continue.

This Special Comment gives our current thoughts regarding those three risks for the industry and discusses several new concerns that have emerged over the past year.

Investment Losses Should Continue Their Decline after Reaching Unprecedented Levels in 2001 and 2002

Bond credit losses reached unprecedented levels for the US life industry in 2001 and 2002. Losses were especially noticeable and painful for the industry relative to the industry's statutory operating earnings, which were already weak. There were wide differences in the level of recognized bond credit losses among the various life insurers as well as a wide range of differences in the companies' accounting recognition of their bond credit losses.

These differences have been extremely difficult for Moody's to get its hands around on a consistent basis. Some companies did realize capital gains to mitigate the impact of the bond credit losses, which can have negative implications for companies' future earnings.

Default rates for bonds declined through the first three quarters of 2003 as the economy began showing signs of recovery and improvement. Moody's forecast is for a continuing downward trend in default rates in 2004.

Nevertheless, we have seen life insurers take continued credit losses in 2003, primarily because of delayed accounting recognition. The level of losses is declining, however, and the worst appears to be over, with the outlook for credit losses being much more positive. However, it should be noted that there are still some troubled industry sectors -- like airlines and telecom - meaning that some life insurers' portfolios are exposed to additional losses.

Whereas bond credit losses for the industry hit 75 basis points of invested assets in 2002, Moody's expects a level of 30-40 basis points in 2003 that will move even lower in 2004, towards the historical norm of 15-20 basis points.

Positive Equity Markets in 2003 Have Improved Many Insurers' Financial Positions

The markets are up by about 20% year-to-date with the result that much of the increased impact of statutory reserve requirements from variable annuity secondary guarantees has been diminished. Statutory earnings and capital improved in the first nine months of 2003 because of lower reserve requirements for secondary guarantees under Actuarial Guideline 34. This is not to imply that the risk has been eliminated, but rather to simply say that this volatile risk is less material now and less likely to affect US life insurers than 12 months ago.

Several companies have also implemented dynamic hedging strategies to better manage their secondary guarantee risk, which we view as a positive. We believe that these hedging programs, which use exchange traded futures on major indices to dynamically hedge changes in the GMDB reserves caused by reductions in equity markets, will be effective at significantly reducing capital volatility for companies. Hedging programs will also reduce NAIC risk-based capital requirements once the C-3 Phase II methodology is implemented.

These hedging programs nevertheless involve complex modeling and, as a result, are subject to the accuracy of many different assumptions regarding lapse rates, investment returns, and market volatility, to name only a few. In addition, there may be some pricing risk and volatility associated with the cost of maintaining the hedging programs. We therefore believe that, because of modeling risk, as well as basis risk related to how well the hedge instruments track the underlying variable annuity investments, there could be additional losses and/or capital implications related to the secondary guarantee exposures.

Companies are addressing these product risks more prudently from a risk management perspective than they did in the late 1990's, but we are surprised and concerned that life insurers continue to offer overly aggressive and risky options to contract holders, apparently driven by the demands of distributors, who are pushing the product benefits to consumers.

The volatile equity markets are also having an impact on revenues and earnings for fee-based products like variable annuities and mutual funds. As assets under management begin to increase, we are seeing earnings on variable products rise once again. The past few years have highlighted how competitively-priced and commodity-like the variable annuity product is. Net sales are running at 25%-35% of gross sales, indicating that much of the industry's growth is simply moving assets from one company to another.

The significant acquisition costs associated with variable annuity products relative to their thin margins underscore the importance of persistency and the exposure of companies to large deferred acquisition cost (DAC) intangible assets on their GAAP balance sheets, as well as their vulnerability to future write-downs if equity markets were to fall again for a sustained period. Significant scale, distribution, investment performance and servicing platforms are all critical success factors that will determine long-term successful survivors, and will drive additional consolidation in this marketplace.

Interest Rates Represent a Long-Term, Rather Than an Immediate Risk

The US life insurance industry is exposed to a sustained low interest rate environment because of minimum interest guarantees on their product liabilities and the potential for spread compression. This is a long-term risk that would take several years of continued low or lower interest rates to have a material impact on the companies' financial performance. We are still several years away from a Japanese-scenario of negative spread. This risk is a "slow bleed" one for the industry compared to the more acute, liquidity-oriented problems that we are more concerned about.

For some companies in 2003, we have seen spread compression of 25 BP on fixed annuities down to a 175 BP range from the usual pricing target in the 200 BP range. Most companies are prudently pricing their new fixed annuity products to account for the low interest rate environment, pulling products off the shelf if permitted regulatory minimum guarantees have not been reduced to market compatible levels. The risk on in-force fixed annuities varies by company, depending on their minimum crediting rates. For most inforce policies, minimum guaranteed crediting rates are in the 3%-4% range.

The movement upward in interest rates since the second quarter 2003 is a positive for the industry. A slow, gradual increase in interest rates, which is a plausible and even likely economic scenario, is the most favorable interest rate scenario for the industry. A reversal and decline in interest rates, by contrast, would put more pressure on industry profitability. A sudden spike in interest rates would be quite negative, as disintermediation risk would become a reality and increased surrenders with resulting losses on the bond portfolio would drain the earnings and capital formation of the industry. Overall, the current economic outlook and likely interest rate movement is more positive than it was 12 months ago.

Thus, if we look at the drivers of the negative outlook, which included credit losses, equity market declines, and low interest rates-all have taken a turn for the better. A stable outlook for the industry and specific companies could result if the positive trends continue and we see meaningful growth in statutory earnings and capital adequacy for a few more quarters.

Moody's has a number of new concerns regarding the industry, which include increased financial leverage, statutory reserve requirements, and mutual fund market timing issues.

Increased Leverage Could Constrain Flexibility of a Few Players

Several companies have taken advantage of the 40-year low interest rate level to issue debt securities and hybrids to recapitalize their operating company subsidiaries, which saw a significant decline in capital adequacy in 2001 and 2002. Refinancing existing debt at lower interest rates is a positive as the company's interest coverage and cash flow coverage ratios look stronger.

But many companies have increased financial leverage and double leverage, which could constrain the flexibility of some players. This highlights the importance of not just analyzing an operating company's capital adequacy, but also analyzing the call on that capital if the holding company has leveraged itself. Interest coverage at most companies still looks steady, however, as the higher amounts of debt are offset by lower carrying costs.

Statutory Reserve Requirements Are Likely to Pose a Greater Problem for Insurers in the Next Five Years

Statutory reserve requirements on guaranteed term life products and no-lapse guaranteed UL products will become quite substantial and meaningful for the industry in the next five years. Regulation XXX and Guideline AXXX will require meaningful increases in statutory reserves and the need for additional capital on business sold over the past few years. Reinsurers and primary companies alike will have an increasing need to fund these reserve requirements with collateral.

Currently, companies are relying on bank letters of credit, which are subject to re-pricing risk and are vulnerable to capacity constraints. As the need for reserves continues to (LOCs) grow, the industry, especially the reinsurers, will need to find funded alternatives, as banks may pull back from providing LOCs, thus leaving the reinsurers with a hole to fill. This situation has implications for both in force and new business.

The reinsurers are primarily impacted, but there are also risks to the primary insurers if the reinsurers can pass on the cost of more expensive LOCs to their cedants, thus hurting the products' profitability for the primaries. If reinsurers can't secure collateral requirements at an attractive rate, then reinsurance capacity will dry up and primaries will have to take on greater mortality and/or investment risk themselves, reduce profit margins, fund substantial capital requirements in the future, or pull back in marketing these reserve-rich term life and UL products.

Mutual Fund Market Timing Issues Could Haunt Some Companies

The final concern is mutual funds and the recent regulatory investigations and accusations. As our readers are doubtless aware, many life insurers own substantial asset management firms that represent a significant portion of their earnings and capital. Some of the better known examples are AXA's ownership of Alliance Capital, Sun Life of Canada's ownership of MFS, MassMutual's ownership of OppenheimerFunds, and Lincoln National's ownership of Delaware.

The mutual fund sponsors accused or alleged to have done improper or illegal market timing, late trading, or personal trading are likely to see net negative flows from their managed funds, which will drive earnings down as assets under management decline. In addition, the costs of improved compliance requirements, regulatory fines, restitution payments, litigation costs, class action lawsuits, etc., are a wildcard at this time, but could be quite substantial, especially in the context of the limited capital held at asset management firms. Finally, the potential for mutual fund fee reductions required by the regulators is likely to cause profit margin compression for asset management firms.

If the earnings, capital, and valuation of an asset management firm are negatively impacted, then the parent life insurance company's financial performance and profile could also be negatively impacted. The significance of this impact on the life insurance company will depend on the size and importance of the asset management firm relative to its parent company, as well as the significance of the wrongdoing.

Some life insurers that value their asset management subsidiary based on the market valuation of the minority ownership could see a significant decline in statutory capital if the stock price of the asset manager drops. We have not yet taken any rating or outlook actions on life insurers that own asset management firms, but this is a very fluid situation. We will have to monitor the developments closely in terms of financial impact and the impact on company reputations.

Moody's does not believe that the reputation damage that could hurt an asset management firm if it is accused of improper or illegal activities will necessarily spill over to hurt the reputation of the owning life insurer in terms of its sales and surrender activity. For most asset management firms, the brand is separate and distinct from the brand of its life insurance parent.

Moody's does believe, however, that the variable annuity operations of most life insurers are subject to and vulnerable to the same market timing and late trading issues that mutual funds have been accused of doing. Moody's knows that the SEC and other regulators have requested information from the top 20 or 25 variable annuity writers. It will probably take some time for the regulatory authorities to move away from the mutual fund industry to the variable annuity industry, but it is likely that several variable annuity writers will be accused of similar activities.

Consolidation Activity Likely to Ramp Up in 2004 & 2005

Moody's expects merger and acquisition activity to ramp up in the next 1-2 years. Our opinion is that, during the difficult times of 2001 and 2002, few companies were willing to leverage their balance sheets or take on the integration and cultural challenges of an acquisition when they were absorbed with their own problems, given the environment. In addition, several of the historical acquirers of US life insurers--the large European insurers--were in a weakened financial position themselves.

Now that the environment is more positive, Moody's expects companies to get off the sidelines and start doing more deals. Transactions will involve both lines of business and legal entities. Company managements and boards are trying to optimize limited capital and to focus their operations on products and markets in which they are meeting profit hurdle rates and are well-positioned competitively.

Some examples of recently announced transactions include: Manulife and Hancock; AXA and MONY; the IPOs of GE Financial and Fortis Inc, and the possible sale of parts or all of Safeco Life and CNA Life.

The US life insurance industry is highly fragmented compared to other life insurance industries overseas and to other financial service industries in the US. The products are becoming all very commodity-like and thin-margined. The markets are intensely competitive, with the distributors gaining incremental presence and power at the expense of the product manufacturers.

Growth rates for most life insurance products over the intermediate term will be in the mid- to high-single digits, with companies consistently exceeding those growth rates probably taking on some inappropriate risks or simply buying market share to improve presence and scale. Returns on equity for most life insurance products can't be much more than 13%-15% or else they are, again, indicative of some higher risk profile.

Stock life companies are once more being put under pressure by their shareholders and analysts to grow the top line, optimize capital deployment, and improve returns to shareholders. Given these pressures and the dynamics in the industry, we expect many companies to eventually throw in their towel on specific lines of business or put their entire company on the sales block.

Related Research

Special Comment

Credit Issues and Trends for US Life Insurance, May 2003, #77812

Rating Methodology

Moody's Rating Methodology for U.S. Life Insurance Companies: 2001 Year-end Statistical Data, February 2003, #77316

Industry Outlook

U.S. Life Insurance,December 2002, # 76637

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

PAGE INTENTIONALLY LEFT BLANK

PAGE INTENTIONALLY LEFT BLANK

PAGE INTENTIONALLY LEFT BLANK

To order reprints of this report (100 copies minimum), please call 1.212.553.1658.
Report Number: 80698

Author	Senior Associate	Senior Production Associate
Robert Riegel	*Marc Abusch*	*Tiffany Lam*