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# A.M. Best's Outlook Remains Stable As U.S. Life Insurers Shift Gears

Despite the challenging macroeconomic environment, A.M. Best Co.'s rating outlook for the U.S. life and annuity sector remains stable. The stable rating outlook reflects generally strong regulatory capital positions, favorable GAAP and statutory operating earnings (i.e., when factoring out accounting anomalies related to hedge accounting and non-recurring events), and continued efforts at improving balance sheet fundamentals through more prudent liquidity and capital management. Despite continued macroeconomic uncertainty, investment portfolios of life insurers have held up well, with most insurers reporting relatively modest investment impairments in 2011 and a return to relatively large unrealized gain positions in their fixed-income portfolios.

Consistent with the current stable rating outlook, A.M. Best's rating actions on life insurers have moved predominantly toward a stable trend. On a financial strength rating (FSR) basis, roughly three-fourths of the life/health companies rated by A.M. Best had stable rating outlooks at year-end 2010. At the end of 2011, the proportion of life/health insurers with a stable rating outlook exceeded 90%. Nevertheless, A.M. Best has some concerns.

Low interest rates will continue to pressure life insurers' earnings, as rates are expected to remain at or near historically low levels until at least mid-2013. However, A.M. Best believes favorable earnings trends are likely to persist, although the growth rate of earnings is expected to slow. Life/annuity companies with more diversified sources of earnings, especially those organizations with businesses whose earnings are largely unaffected by interest rates or domestic equity markets (e.g., property/casualty, non-insurance and international operations), are expected to fare better. As the specter of low interest rates hangs over the industry, some companies have issued public statements specifically about the impact of low rates over a sustained period, showing a modest impact on earnings. A.M. Best believes the impact will be felt over time as long-term investments mature and cash flows are reinvested at depressed new money rates.

After starting out the fourth quarter in the 40s, the Chicago Board Options Exchange Market Volatility Index (i.e., the VIX) has hovered in the high 20s to low 30s for most of the period, and it appears the generally low trading volumes and seemingly daily headline risk are going to result in continued higher volatility in both the equity and fixed-income markets. The more volatile U.S. equity market and low interest rates have increased hedging costs and resulted in additional reserve increases for equity-sensitive product lines. Moreover, equity markets generally have declined across the globe on concern that the European Union does not have the tools to fully cope with the sovereign debt crisis and the potential that a European recession could dampen global growth. As a result, government bond yields have ticked up, while credit default swap spreads on investment-grade credit have widened a bit.

Still, asset portfolio valuations can swing wildly, as was seen during the financial crisis. Some insurers have taken advantage of stability in some of the more distressed asset classes to pare their positions, while others have moved down the credit scale in an effort to generate yields. This "enhanced yield" strategy carries some risk and will need to be monitored closely if economic conditions deteriorate.

Economic conditions already have worsened in the eurozone, which recently has prompted A.M. Best to take a number of negative rating actions on U.S. life insurers owned by European parents. A.M. Best believes that domestic entities' exposure to the sovereign credits of Greece, Italy, Ireland, Portugal and Spain (aka "PIIGS") appears to be quite manageable. However, contagion risk to segments of the financial industry, such as banks and insurers, is certainly possible and would make it more difficult to keep ratings stable.

Given continued equity-market volatility and low interest rates, some carriers have reassessed their plans for variable annuities. This strategy has ranged from modest product tweaks while maintaining aggressive growth and market share, to completely exiting the market. One factor contributing to the strategy is differing regulatory regimes and risk charges/capital requirements associated with this business. In addition, hedging costs have risen as markets became more volatile. In certain cases, the cost of hedging a sizable variable annuity book has exceeded the fees charged for the hedges, resulting in additional fee increases for living benefit riders. Overall, A.M. Best believes hedge programs have performed as expected. While earnings volatility has been significant in some cases, regulatory capital ratios remain healthy. Nonetheless, while companies have been proactive in making changes to their new product offerings, legacy blocks with substantial positions "in the money" will continue to pose a challenge.

A.M. Best has observed that some companies have taken proactive steps to protect against the sustained low interest rate environment through refinement of investment allocations, reduction of interest rate minimum guarantees and hedging strategies such as the use of interest rate swaps, purchase of Treasury locks and other portfolio management tools. Others have shifted their business strategies away from product lines that are either too capital intensive or simply not meeting their targeted returns. In addition to the contraction of players in the variable annuity space, certain life insurers recently have announced they are exiting or deemphasizing lines such as fixed annuities, banking, Medicare supplement, group medical and long-term care. At the same time, life companies are expanding into international markets (largely through acquisition) and in domestic lines such as employer stop-loss, fixed indexed annuities and voluntary benefits sold through the worksite. Additionally, A.M. Best views favorably the re-emphasis by key industry players on life insurance sales, and more specifically whole life, whose stable, long-term earnings have a beneficial impact on companies' credit profiles.

Life insurance companies are continuing to undertake "redundant" reserve financings, mainly using domestic captive subsidiaries/affiliates to free up capital, essentially bringing forward future cash flows in favor of prospective earnings. A.M. Best will continue to look through these transactions, analyzing groups on a consolidated basis using its capital model, regardless of which affiliated entity assumes the risk. Moreover, the adoption of new accounting for deferred acquisition costs on a retrospective basis will have a meaningful impact on GAAP shareholders' equity, but A.M. Best believes the overall impact is manageable, as there is no real change in the economics of the businesses.

Finally, A.M. Best remains concerned about more aggressive capital management activities, especially given the recent uptick in publicly traded companies' share repurchases. Although A.M. Best recognizes the attractiveness of this option to deploy capital efficiently while shares trade at a discount to book value, it should not come at the expense of maintaining prudent capital positions at the life insurance subsidiaries.

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