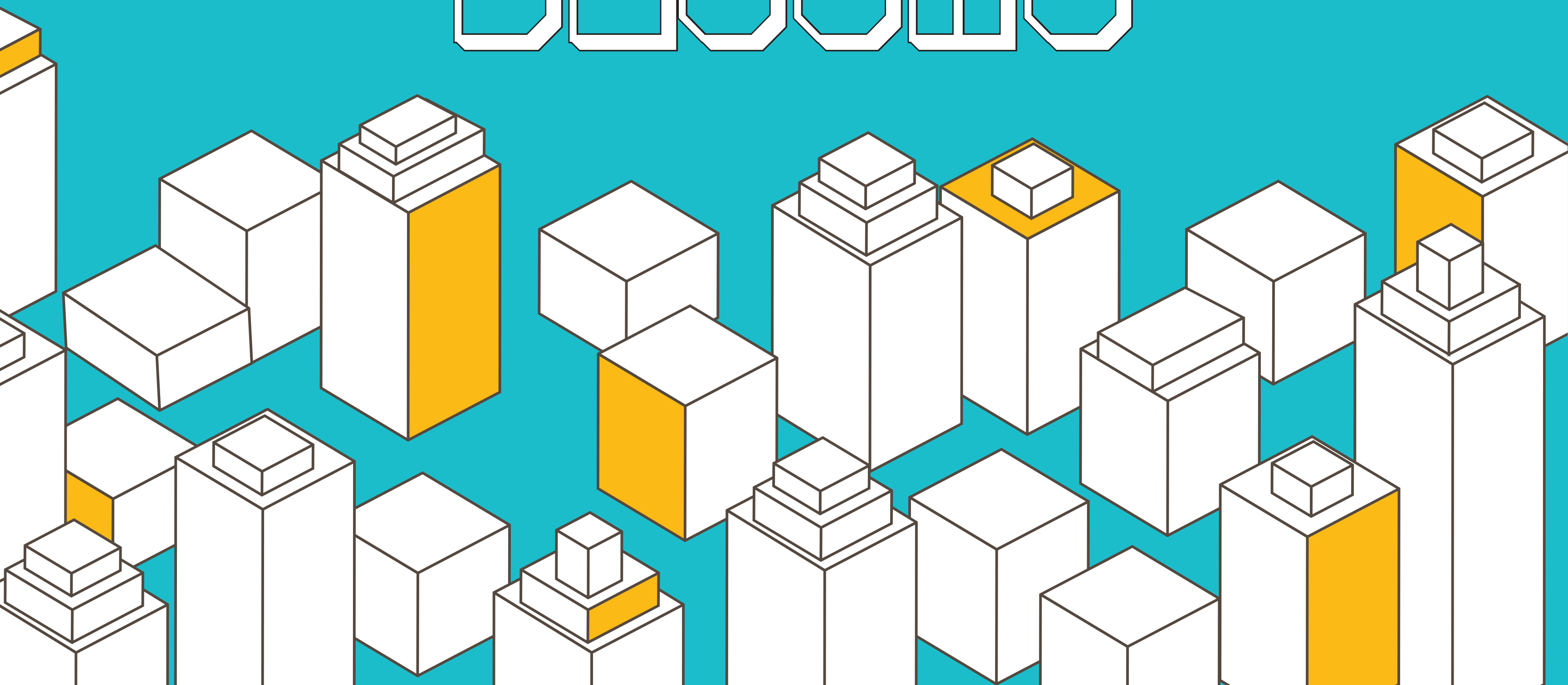
SOCIETY OF ACTUARIES

Article from:

The Actuary Magazine

August/September 2013 – Volume 10, Issue 4

LESSONS LEARNED FROM LEGACY BLOCKS



WOULD LIFE INSURANCE COMPANIES BE BETTER SERVED BY FOCUSING ON BETTER WAYS TO DELIVER OUR PRODUCTS, BETTER SYSTEMS TO GUARD AGAINST ANTI-SELECTION (CLAIMS MANAGEMENT AND UNDERWRITING), AND BETTER WAYS TO SERVICE OUR CLIENTS TO IMPROVE PERSISTENCY? "ABSOLUTELY," SAYS THIS AUTHOR. BY RONALD KLEIN

I am always fascinated by the lack of understanding in the general population of an actuary's first love—statistics. While there are many examples that can be seen every day on television or in the newspapers, I would like to share with you a few of my favorites.

BRAINERS AND NO-BRAINERS

In a local newspaper that I used to read while living in the United States, there was a column written by Marilyn vos Savant called "Ask Marilyn." For those of you who have never heard of Marilyn, she was once listed in the *Guinness Book of World Records* as the woman with the highest IQ—190. The great thing about her column was that many of the questions were scientific or mathematical in nature.

There is one question that I will never forget: "I am always confused by the weather forecasts when the meteorologist says that there is a 20 percent or a 30 percent chance of rain. Either it rains or it doesn't. Isn't there always a 50 percent chance of rain?" Now, this is a guy we want to purchase our insurance policies. "Hey! Do you want to buy a one-day life insurance policy? The face amount is $1 million, and the premium is $400,000. Either you die tomorrow or you don't, so it is a good deal!"

Another of my favorite examples is when I was working for a reinsurance company, and a group of investors in the life settlements market called to offer me a great deal. All I had to do is take on the longevity risk of the policies that these investors purchased two years after the life expectancy of a policyholder was reached. "Yo, Ronnie, it is a no-brainer. This is a full two years after life expectancy, so how many people will live that long?"

(Not ever professing to having a brain, I am always confused by the term "no-brainer." Does this term mean that you can understand the offer only if you don't have a brain, or is it that the person making the proposal has no brain?) I actually had to explain to this group of investors that the odds of living past your life expectancy is about 50 percent, so they might want to review their investment.

LEGACY BLOCKS

But it is the third example that leads us to the theme of this article—*Lessons Learned from Legacy Blocks*. I read a *Wall Street Journal* article some years ago, and although I cannot remember the exact headline, it was something like "Study Shows that 50 Percent of Life Insurance Company Acquisitions Better for Seller." Wow! That is an interesting fact. You have two extremely sophisticated parties entering into a large financial transaction—one wins and one loses. Who is surprised that half the time the buyer wins and half the time the seller wins? One day, someone can explain to me the win-win scenario.

Legacy blocks of business are typically created in numerous situations including the following:

1. A company simply decides to exit a line of business to focus on core businesses
2. A product line was introduced but sales did not meet expectations, so management decided to exit this line of business
3. Regulations changed, causing a specific product or products not to be viable any longer or
4. A product line is underperforming due to policyholder behavior, poor assumption setting, or economic conditions.

It is this last situation that we will use to define legacy blocks for the purposes of this article. The lessons learned should be how to avoid developing products that will become legacy blocks in the future.

DEALING WITH LEGACY BLOCKS

With the current and sustained low interest rate environment, many blocks of business are becoming legacy blocks. As these blocks of business begin to underperform company expectations, there are a few courses of actions that a company may take:

1. The company may continue to sell the product in hopes that the interest rate environment will improve
2. The company may continue to sell the product, but reprice it so that the product is profitable under the current market conditions
3. In addition to category 2, the company may attempt to raise rates on the in-force policyholders to whatever extent possible
4. The company may cease selling the product and
5. The company may attempt to sell off the poorly performing block of business to commute its losses.

At the 2013 ReFocus Conference, with more than 450 people in attendance representing almost every major U.S. life insurer (and every U.S. life reinsurer), an audience response question asked what your company has done to mitigate the effects of low interest rates on product profitability. Amazingly (to me) a large percentage of replies fall into category 1—continuing to sell the product in hopes that the interest rate environment will improve!

If interest rates continue at their record lows for a few more years as predicted by many governmental organizations around the world including the U.S. Federal Reserve, many more legacy blocks will be found on company balance sheets and many more up for sale. This is good news for the ever-increasing number of reinsurance brokers and intermediaries trying to make a commission by matching up a buyer and a seller.

If your company is in the business of looking for "bargains" during this period of low interest rates, beware of the statistic in that *Wall Street Journal* article. About half the time you will make a poorer than expected return on that investment! Burying your head in the sand and hoping things will get better could be a dangerous strategy. Selling off blocks of business at the worst possible time could be even more dangerous. While taking corrective action quickly is a good solution, avoiding the creation of legacy blocks is a clear winner.

SO HOW DID WE GET HERE … AGAIN?

The largest contributors to poorly performing blocks of business are the products with fixed interest rate guarantees. We all know about the guaranteed interest rate products sold in the United States; however, many of these

REPORTS OF INTEREST

HERE ARE SOME RELATED RESEARCH reads for managing blocks of business that focus on policyholder behavior that may be of interest.

RESEARCH STUDIES

- Policyholder Behavior in the Tail Risk Management Section Working Group UL with Secondary Guarantee 2012 Survey Results
- Policyholder Behavior in the Tail: Variable Annuity Guaranteed Benefits—2011 Survey Results
- Behavioral Simulations: Using Agent-Based Modeling to Understand Policyholder Behaviors

For more reports, visit *www.soa.org/Research* and click on Completed Research Studies.

EXPERIENCE STUDIES

- 2007-09 US Individual Life Persistency Update
- Lapse and Mortality Experience of Post-Level Premium Period Term Plans

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investment-type products are sold outside of the United States, where it is quite common to offer an interest rate guarantee on deposits with a small additional benefit on death—say, 1 to 10 percent of the fund value.

Many of these products were sold in times of higher interest rates, so the product guarantees reflected the current interest rate environment. I have seen guarantees of 3, 3.5, and even 4 percent on some of these products. While this in itself is not the problem, it becomes a problem if insurance companies did not match their liabilities well. Given that these products may have a duration in excess of 30 years, perfect matching was not possible.

Companies are now faced with two issues:

1. Reinvestment rates that are well below the guaranteed minimum interest rate in the product and
2. Having to set up reserves using a regulatory interest rate that can be lower than the actual investment yield.

Even if a product is perfectly matched, reserving can be a major issue. While some countries have relaxed reserving requirements in fear that the entire industry would be considered bankrupt, other countries have created new additional reserving regulations. Germany, for example, has instituted the Zinszusatzreserve (ZZR), which requires insurance companies to hold additional reserves for the present value of the difference between guaranteed interest rates and current government rates. This puts a huge strain on companies (although, due to a participating fund in Germany, some companies actually view this regulation welcomingly).

What makes insurance companies sell investment-type products in times of higher interest rates, with a relatively high minimum return? One theory is that insurance companies want to be more like banks. For those insurance companies' CEOs I have one comment: Be careful what you wish for! These same CEOs are now "returning to protection products." Why we ever left protection products, I will never know.

The lessons learned should be how to avoid developing products that will become legacy blocks in the future.

Insurance companies are in a unique position to take on risks that other organizations run from. Insurance companies should profit from the ability to take on risk. There is always the fear looming that if insurance companies become more like banks, they will be taxed like banks and lose the tax-free status on cash values. Having worked for multiline insurance companies during the past 20 years, I am always amazed at how our non-life brethren seem to be able to make profits on medical insurance and accident and health insurance. Could it be the short-term, reviewable rate nature of this line of business?

NOTHING LASTS FOREVER

The low interest rate environment should teach us, once again, that interest rates go up and come down. The stock market goes up and comes down. Company expenses go up and … well, let's just say they go up. In other words, markets are volatile, and offering unhedged guarantees can be quite costly.

The liability part of the balance sheet of many companies is littered with blocks of business that are closed to new business due to market conditions. These legacy blocks include variable annuities with guarantees, investment-type insurance products with minimum interest rate guarantees, and equity-based products with guarantees. With the U.S. stock markets at all-time highs, will it be long before the industry reinvents new equity products with guarantees?

The main thing to learn when reviewing your legacy blocks of business is that things do not last forever. For example, look at 10-year U.S. Treasury rates during the last 140 years (rates taken on Jan. 1 of the year). From 1871 to 1935 rates varied by 1 percentage point around 4.5 percent, never really going below 3.5 percent and never really topping 5.5 percent. From 1935 to 1950, rates never were above 3 percent and dipped below 2 percent in 1941.

After 1941, a dramatic increase in interest rates began that peaked at about 15 percent in 1982 (just about the time I bought my first house with my first huge mortgage). These rates stayed in double digits through 1985 and above 8 percent through 1991. As an actuary entering the field of insurance in 1980, I would never have dreamed that interest rates would ever be below 2 percent again—let alone for such an extended period of time.

In fact, given the opportunity, I would have developed a product with a minimum guaranteed interest rate of 4 or even 5 percent. Luckily I was in the disability income department at that time developing own-occupation riders!

Have we already forgotten just a few years ago when our 401(k) accounts turned into 201(k) accounts? Just because the market is back to record-high levels, does that mean that it will continue to go up? Products need to be developed without these financial guarantees that are better left to banks. Isn't it enough that we guarantee mortality rates in our products though guaranteed premiums?

Life insurance companies will continue to change strategies by entering or leaving markets. This will create blocks of business in runoff. These blocks can be strategically sold (if in a separate company) or reinsured with or without administration performed by the reinsurer. What the industry should avoid is the creation of legacy blocks of business due to unsustainable guarantees and options.

Would life insurance companies better be served by focusing on better ways to deliver our products, better systems to guard against anti-selection (claims management and underwriting), and better ways to service our clients to improve persistency? While not sexy, these straightforward methods are sure to produce results. In fact, they are a no-brainer!

LET'S MAKE A DEAL … BUT NOT BRING HOME A GOAT

I would like to end with Marilyn's most famous column topic—the Let's Make a Deal scenario. You all know this one, but I will restate it briefly. You have the choice of one of three doors. Behind one door is $100,000. Behind the other two doors are goats (actually, I now live in Switzerland, and a goat would be a much more efficient and environmentally friendly way to mow my very small lawn).

You choose one door, and then the master of ceremonies reveals a door that contains a goat. You now have the choice to switch to the other door or stay with your original choice. What should you do to increase the odds that you will win the money?

Basically, the population is split between staying pat and switching. I am firmly in the camp of switching. Let me know where you stand. I will keep a running tally and send the results to the Society of Actuaries to post on its website.

In the end it is simple: Let's try to stay away from creating legacy blocks of business and winning goats! It's a no-brainer. A

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