An Industry in Question, A Profession with Answers

by James Ramenda

The current financial crisis is sometimes described as a process of "washing away" economic excesses. Yet for a widening range of industries, it seems that more than just excesses are being washed away. Major companies, long-standing ways of doing business and thousands of jobs are disappearing, seemingly overnight in some cases. Today's constant flow of information and the globalization of markets reinforce the "real time" nature of the crisis. Balance sheets are viewed as trading positions, marked to market with each new data point.

Among all financial institutions, insurance companies may be the least strategically suited to this environment because of the potentially decades-long nature of their liabilities. And among insurance companies, life insurers face particular pressure owing to three characteristics of their business: (1) they have the longest duration liabilities, i.e., permanent life insurance and long-term annuities, (2) these are demand liabilities, and (3) these lines have the highest asset leverage relative to capital. The leveraged effect on balance sheets has been severe, with equity accounts of many major publicly traded life insurers down 20 percent or more through nine months of 2008 and likely to fall further by year-end. The S&P 500 life insurance component is off more than 50 percent in 2008 through mid-November, and several companies have suffered substantially more severe declines. Whether the market's harsh judgment will prove correct in the long term is anyone's guess at this point, but at a minimum the crisis is raising some new questions for the industry.

The central question is that of viability. Specifically, is the configuration of life insurers' products and balance sheets economically viable under current accounting and ongoing market conditions? Life insurers make long-term investment guarantees in their life and annuity policies. The assets backing these products are chosen to mature the liabilities over the long term, not to match them in value moment to moment. The result is that interim swings in equity can be large, but not necessarily meaningful to a company's ability to meets its obligations and produce a profit. Indeed, no major life insurer has reported difficulty paying claims or meeting solvency requirements to this point.

In theory, the impact of a market-driven decline in equity is dampened by statutory accounting principles, which judge solvency based largely on historical cost measures. Even under GAAP, such a decline theoretically is balanced to some extent by the prospect of higher future earnings due to widened spreads. However, the reality of the marketplace is that a sizeable decrease in book value brings other consequences: ratings downgrades, short-selling raids, potential runs on the company, distressed asset sales and discounted capital raise-ups. Under such stress, a company may need to sustain itself by selling deeply discounted assets and raising capital at highly dilutive terms, actions which sharply reduce future profitability.

Moreover, even if the recent severe declines in equity prove to be temporary, insurers will still need to incorporate the observed market data into their forward-looking risk management scenarios, e.g., the VIX above 60 (and surging to nearly 90); investment grade bond spreads up to 500 basis points; performing AAA commercial mortgage spreads of 600 basis points. Perhaps these extremes reflect "fire sales" conducted by severely distressed sellers, but they cannot be discounted as 1-per-1,000-year events, "black swans," or "Great Depression" scenarios. Recognition of increased risk will require deleveraging of the life insurance business, as is occurring in other financial industries.

Deleveraging can be accomplished through capital-raising, but at the present time the public markets are not accommodating. Many leading companies are trading at fractions of their book values, some as low as 20 percent (of book value as stated, i.e., reflecting fair value accounting). The debt of some household names in the industry trades at junk bond spreads despite investment grade ratings. It may be that markets simply distrust insurers' balance sheets, or are discounting still worse days to come. Perhaps markets are simply in a panic, but it is noteworthy that generally higher valuations are being awarded to property-casualty and certain health insurers vs. life insurers, these having shorter duration business, no demand liabilities and lower asset leverage. Markets may be rendering their verdict on the question of viability of the underlying business, i.e., they won't provide the capital to support long-term investment-based liabilities underwritten by life insurers.

With private capital not forthcoming, it is likely the life insurance industry will join the banking industry (and perhaps other industries, e.g., auto manufacturers) and recapitalize through direct investment from the U.S. Treasury. It has also been suggested that insurers receive FDIC-type backing to shore up policyholder confidence. If these steps were taken, it would be reasonable to assume that the time for federal regulation over insurer solvency would be near. As with banks, if the federal government is going to backstop an industry, it is going to have a greater regulatory say. Though once resisted by much of the insurance industry, many companies would now welcome a move toward this Canadian-type approach to regulation. It might also be logical to expect greater regulation of insurance holding companies to monitor the build-up of risk to the enterprise at that level.

Whatever its form, future regulation will almost certainly reinforce deleveraging. If so, insurers will need to back their risks with more capital, reduce the guarantees they provide, limit the risks they cover and attempt to increase their prices to maintain returns. For economists, this suggests a lower equilibrium quantity point for risk transfer. In everyday terms, it means less coverage for breadwinners, less income for retirees and less continuation for businesses.

Of course, in addition to their risk-bearing function, insurers are also investors. And being long-term businesses, they are by definition among the few long-term investors remaining in the world. Historically, insurance companies were among the buyers of last resort for distressed properties, able to buy, hold and manage these assets when few others could or would. In the Great Depression, many insurers ended up owning vast swaths of land and innumerable commercial and apartment buildings, property which eventually proved highly valuable and contributed to the foundation of many industry giants. But even before the current economic crisis, the ability of insurers to act in this capacity had already become limited by fair-value accounting measures (FAS 159 and its forerunner, FAS 115) due to the potential wide swings in market value such assets entail. Insurers seem destined to be even more risk-averse investors in the future.

All of this is not to pass judgment as to whether fair-value accounting is inherently good or bad, or whether more regulation is inherently good or bad. Rather, it is simply an observation that changes to accounting rules have tended to diminish the industry's ability to act as a long-term stabilizing force in the economy. The depth of the current crisis and the capital markets' dire assessment of the industry may put a permanent stamp on this trend.

For many of us in the industry, this seems like a sadly counterproductive outcome. But we have to answer critics who would argue that had the industry been more risk-averse, it would not be verging on a bailout from taxpayers. This is a pivotal moment for the industry. The actuarial profession needs to be heard in several key areas:

1. Determine whether the industry's business model (i.e., current products, investment practices, capital ratios, holding company leverage standards, etc.) is viable in view of ongoing capital market conditions. This includes examining the impact of fair value accounting and whether it has created additional risk or simply identified it.
2. Every effort must be made to see that the profession's analyses inform the development of future regulation, including the form, terms and amounts of potential capital infusions or guarantees from the government.

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3. Develop a system of reporting the financial condition of life insurers that would replace the tangle of GAAP statements, "non-GAAP" measures and statutory statements with a single set of highly transparent financial statements. Such statements should include a unified set of experience assumptions, a validation of the assumptions using actual experience and explicit means of reconciling measures used in the capital markets with those used in the determination of solvency. This will necessarily mean the transformation of solvency accounting from a separate set of principles to a set of transparent adjustments to prevailing GAAP.

Public markets doubt the viability of the life insurance industry's business model. It is possible policyholders may someday follow suit. For the actuarial profession, this is a challenge on par with the need for Social Security and Medicare reform. It must provide the objective tools and analysis needed to either reaffirm or re-establish the viability of the life insurance industry.

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