

Analysis of Life & Health Insurer Impairments

Introduction

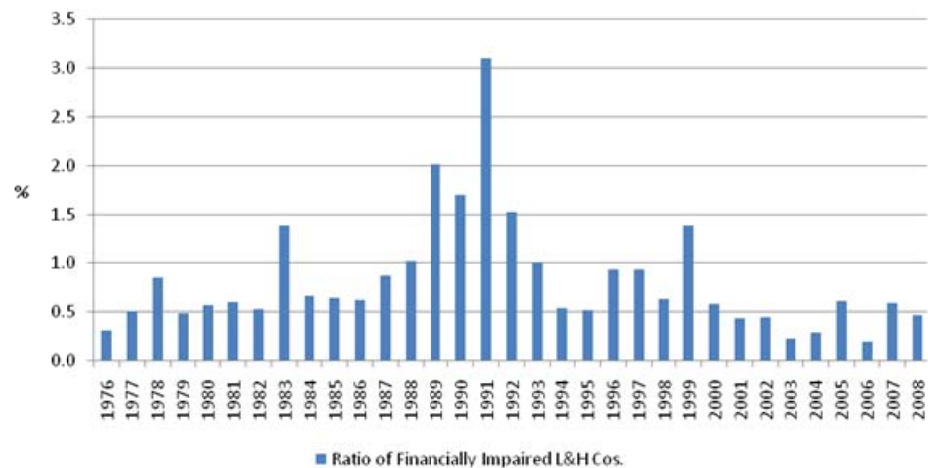
Life insurers have fared well relative to banks in the recent economic meltdown and recession. Further, life insurers have fared well even when compared to historical average failure rates. The purpose of this bulletin is to look at the relatively low historical failure rates for life insurers, examine the most common risk factors that contribute to life insurer impairments, and discuss safeguards that have evolved over the last 20 years to minimize the impact of those risk factors. The bulletin also reiterates the effectiveness of policyholder protections, even when a carrier experiences financial challenges.

History of Life Insurer Impairments

A.M. Best has historically tracked U.S. Life & Health (L&H) insurer impairment rates (table 1). From 1976 until 2008¹ the rate of financial impairments for L&H companies averaged 0.88%. In 2008, the impairment rate was 0.46%, below the average for the period. Even during the period when impairment rates peaked (1989 until 1991) in which nearly one-third of all impairments for the study time period occurred, the rate reached a high of only 3.1% (in 1991).

Please note that the following data includes health insurers.

Table 1. Annual Ratio of Financially Impaired Life & Health Insurance Companies



Source: A.M. Best

It is important to note that the overwhelming majority of life insurers that fail are small companies with \$20 million or less in capital and surplus. The average annual failure rate for those companies is 2.28%, 76 times greater than the failure rate for companies with capital and surplus in excess of \$500 million (0.03%). M Financial's Carrier Partners each have capital and surplus in excess of \$500 million.

However, there have been some notable insurer failures involving large companies².

Life insurance due care requires an understanding of the factors that impact policy performance and drive product selection.

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insurance due care and client advocacy,

providing valuable insight and analysis

that delivers

significant value

to clients.



It is also important to note that in the rare occurrence of an L&H company failure, policyholder interests remain a priority and every effort is made (via regulators, court appointed receivers, and/or the facilitation of a sale to another company) to make policyholders whole.

Causes of Life Insurer Failures

While life insurer failures are relatively rare, the risks that have historically contributed to them have been fairly consistent. The risks include:

- **asset quality/diversification**
- **liquidity (short-term demand liabilities backed by longer-term asset maturities)**
- **poor management**

These risks can be viewed as similar to those impacting the banking industry. However, while insurers and banks are similar in that they both accept premiums/deposits and invest primarily in debt instruments, they are different in one very important characteristic: bank deposits can typically be accessed immediately by depositors, but policy values with life insurers are being used to fund long-term contract obligations and are not typically subject to fluctuations in liquidity demand. Therefore, during periods of macro-economic or financial stress, the impact on banks—relative to life insurers—is typically greater due to depositor concerns about liquidity.

Another key point regarding life insurer failures is that size matters. As stated earlier, companies with capital and surplus below \$20 million are 76 times more likely to fail than companies with capital and surplus in excess of \$500 million. The reasons for this difference in failure risk can be traced to diversification. Small companies are less able to diversify their assets and their business lines. This leaves them more vulnerable to asset quality deterioration, issues arising from mispriced policies, and higher-than-expected claim experience.

Industry Safeguards

In response to the failures of a few large life insurers, the National Association of Insurance Commissioners (NAIC) responded with regulatory changes designed to prevent similar failures in the future. One major initiative was the adoption of risk-based capital (RBC) standards for L&H insurers along with benchmarks for when state regulators should intercede in a company's operations to protect policyholders. RBC addresses the issues of asset quality and business diversification, as well as other risks that could threaten an insurer's solvency. RBC takes into account an insurer's asset quality and business diversification risks. Required capital is increased when insurers take on more risk. The rules adopting RBC also provide model recommended actions for states based upon a company's RBC ratio with the objective of protecting policyholders. The recommended actions range from no action all the way to mandatory seizure. In addition to RBC, insurers are required to perform cash flow testing, which helps insurers better identify and manage liquidity risk.

Other tools used by regulators to monitor life insurers and encourage behavior that provides greater protection for policyholders include:

- **solvency indicators**
- **dividend restrictions on payments to holding companies**
- **conservative reserve requirements for policy obligations**
- **Statutory Accounting Principles (to assist in determining the ability of an insurance company to pay its future claims)**

The life insurance industry is also monitored closely by several third-party ratings companies. These ratings companies analyze a variety of quantitative and qualitative factors and assign financial strength ratings to life insurers and their subsidiaries. In response to the large failures seen in the early 1990s, most have also formulated their own risk-adjusted capital and liquidity measurements to aid in determining each company's capital strength

and quality of asset/liability matching. In addition, the ratings companies perform stress-testing scenarios to evaluate how each carrier's financial health will respond to difficult economic and financial conditions. However, while third-party ratings companies generally cover most or all large life insurers, they often do not cover smaller life insurers. This may also help to explain why smaller life insurers have a higher failure rate.

Conclusion

While the life insurance industry does not have a perfect record when it comes to failures, it has historically done a very good job of handling periods of economic and financial stress. Regulators have adapted capital adequacy and asset quality rules governing life insurers to address risks that previously contributed to the largest life insurer failures. As a result, most failures occur within small companies that lack diversification, transparency, and/or quality management.

As a result of the current economic cycle, nearly all life insurance companies are finding themselves weaker financially. However, virtually all companies are expected to survive it, as demonstrated by Standard & Poor's recent comment that, "[I]t speaks to the industry's overall strength that despite the harshness of this cycle, 95% of the life insurers we rate still carry investment-grade ratings."³

M Financial Group will continue to monitor and evaluate developments relating to the industry as a whole. If you have any questions or comments, please contact any member of the M Product Management team at 800.656.6960.

¹ Data for 2009 is not compiled until the end of the 1st quarter of 2010. The largest life insurer failure in 2009 is believed to be Shenandoah Life, which did not file a 2008 statutory financial statement and reported surplus of \$125.8 million at the end of 2007.

² A.M. Best does not consider the life insurance operations of American International Group Inc. (AIG) as qualifying for the definition of "financially impaired." Despite receiving federal financial assistance, the majority of AIG's problems involved the holding company and non-insurance subsidiaries and not the insurance operations.

³ Standard & Poor's, "U.S. Life Insurance 2010 Outlook: Earnings Will Be Key To Maintaining Ratings," January 26, 2010.

For More Information

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Appendix

Major Life Insurer Failures

Note: It is important to note that in the rare occurrence of an L&H company failure, including those noted below, policyholder interests remain a priority. Every effort is made (via regulators, court appointed receivers, and/or the facilitation of a sale to another company) to make policyholders whole.

Executive Life – Sold interest-sensitive life insurance products that projected high rates of return and invested heavily in below-investment grade, or “junk,” bonds. The company did not have a large amount of inforce policies so it was able to generate high yields on its investment portfolio when interest rates were high. The company grew quickly as a result of its sales of products with illustrated competitive advantages. The junk bond market collapsed in 1990 and caused the company to have substantial losses in its portfolio. Regulators seized the company after determining the company was insufficiently capitalized.

While policies issued by affected companies were sold to other companies to preserve benefits, some annuity holders suffered lower benefits as a result of the sale of the underlying junk bond portfolio to a French bank by the state of California. The portfolio was sold at fire-sale prices yielding an estimated \$2 billion profit for the bank. Ultimately, lawsuits were filed against the bank and judgments against it yielded several hundred million dollars for policyholders.

Mutual Benefit Life – Sold large amounts of guaranteed investment contracts (GICs) in the 1980s to pension plans and supported the high rates of return on these contracts by investing heavily in real estate, particularly in California and Florida. When the real estate market bottomed out in 1991, fears of the company’s demise caused a significant increase in surrenders by policyholders. By the time the state of New Jersey took control of the company, Mutual Benefit’s liabilities exceeded its assets.

All policy liabilities were ultimately transferred to other insurers and Mutual Benefit Life was liquidated and dissolved.

Confederation Life – The Canadian life insurer began investing much of its portfolio in real estate and mortgages (up to 71% at one point) in the 1980s in order to achieve high rates of return to support, among other products, GICs sold to pension plans. The 1980s real estate bubble burst in the 1990s and by the time regulators shut the company down to prevent a run by policyholders, the company had lost \$1.2 billion. In retrospect, it was determined that poor management contributed to the company’s lack of diversification, as well as the entry into business lines that helped precipitate its demise.

Transfers of the policy obligations from the U.S. subsidiaries to other life and health insurers were arranged by state guaranty associations.

General American Life – Sold GICs to pensions and institutional investors promising they could receive their principal plus interest within seven days of redemption. The company had invested in longer-term investments to generate attractive rates of return. In 1999, the company’s credit and financial strength ratings dropped below the standards written into the contracts. As a result, the contracts were called, forcing General American to pay investors \$5 billion. Lacking the liquidity to redeem the contracts, the state of Missouri took control of the company and found another insurer to buy the company and meet obligations to contract holders. General American continued to operate as a going concern after the sale.