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Midyear 2009 North American Life Insurance Outlook: Dicey Conditions Will Continue To Rattle A Staid Sector

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Standard & Poor's Ratings Services is maintaining its negative outlook on the U.S. life insurance sector. Our outlook on this sector has been negative since October 2008, when we revised it predominantly as a result of the economic downturn. Since then, there have been numerous downgrades, and we expect little change in the economic conditions that led to them. Despite all the unfavorable rating actions so far, we anticipate that over the next six months to a year, downgrades will continue exceed upgrades, though downgrades generally will be limited to one or two notches (for example, 'AA' to 'AA-' or 'A+').

This recession, which will likely be the worst economic downturn since the 1930s, has dampened life insurers' investment portfolios and earnings. At the same time, their access to the credit markets is limited, reducing their financial flexibility and pressuring holding-company liquidity.

In light of relatively scarce and expensive capital, life insurers are slowing their growth plans to maintain appropriate capital adequacy. Insurers are also coping with the challenges of navigating the less-predictable consumer behavior risk on annuity withdrawals, which this uncertain economic market heightens. Finally, the many insurers with large variable annuity businesses are seeing returns in that segment whipsawed by sagging equity markets, which are driving higher capital and reserve requirements, and are struggling to implement new product changes.

To be sure, the life insurance sector does have some strengths, even in this period of economic pressure and reduced profitability. Despite the challenges the industry is facing, most life insurers have capital that supports the particular rating and are still in a strong position to meet both policyholder and debt obligations. (Most insurers' cash flow is sufficiently stable because of well-matched liabilities and assets, both for long- and short-term needs.) In addition, the sector remains well positioned to capture the needs of an aging demographic market, the demands of which might have increased given the recent decline in personal wealth. Protection and wealth accumulation for retirement remains a core need, and only insurers have the ability to offer guarantees to support these products.

Moreover, although portfolio income could be lower because of reduced private equity distributions and a shift to cash and higher-quality bonds, life insurers still typically have more limited exposure to the more problematic assets—principally various mortgage-backed securities—that have caused trouble elsewhere in the financial system. In our assessment of capital adequacy, we account for portfolio assets, which are mainly investment-grade corporate bonds, on a statutory book value and not a mark-to-market basis. That difference reduces the effect of asset impairments and markdowns, easing the need for more statutory capital.

However, in our analysis of an insurer's portfolio value—which looks at the ability and intent to hold underwater securities to maturity—we weigh liquidity more heavily than we do accounting. If we consider the liquidity profile stable for the asset and liability risks, we rely on our assessment of expected economic losses as opposed to the currently more onerous mark-to-market losses.

Despite these mitigating factors, we believe the life insurance industry will continue to suffer from the larger economic realities. Standard & Poor's doesn't believe the economic malaise will begin to lift until late this year or

early 2010. In general, life insurance and annuities are an infrequent purchase, so sales tend to remain muted when consumers are out of work or struggling to meet more pressing day-to-day expenses. In addition, we're most likely to see a significant rebound in investment income—despite wider spreads currently—and asset quality only when the economy picks up. There is one big caveat, however: An unexpected increase in economic deterioration beyond our current assumptions could easily mean further degradation in credit quality and potentially lower ratings.

Ratings Could Continue To Slip

The difficulties in the life insurance sector are reflected in the disproportionate share of negative rating actions we have taken so far this year. Through May 4, we upgraded no insurers and downgraded 24 of them (see Chart 1). The downgrades in 2009 come on the heels of 10 earlier ones in 2008, when we upgraded only four issuers in the sector.

This year, many life insurer downgrades followed our subsection of the sector to a revamped capital stress test that took into account the worsening economy (see "Methodology For Incorporating Incremental Stress Factors Into The Capital Adequacy Analysis Of North American Insurers," published on Feb. 18, 2009, on RatingsDirect). In those tests, we determined that many insurers' capital and financial flexibility could be more vulnerable to the recession than we had previously thought, with much of the stress attributable to the potential further deterioration in corporate bond portfolios.

Nevertheless, the vast majority of life insurers still retain investment-grade ('BBB-' or higher) ratings (see Chart 2). Although there has been a slight increase in speculative-grade ('BB+' or lower) ratings in the past three years, to three of the 84 rated issuers from one, the overwhelming majority of insurers fell into the 'AA' category (46%) or 'A' category (36%). We've even seen a slight increase in the small number of 'AAA' insurers, to six from five.

What's more telling are the outlooks we've assigned. A year ago, only 8% of our issuers had negative outlooks. Currently, 46% do. Similarly, 81% had stable outlooks a year ago as opposed to only 48% now (see Chart 3). Clearly, the revision of so many outlooks to negative is a signal that we believe credit quality will get worse before it gets better.

Chart 1

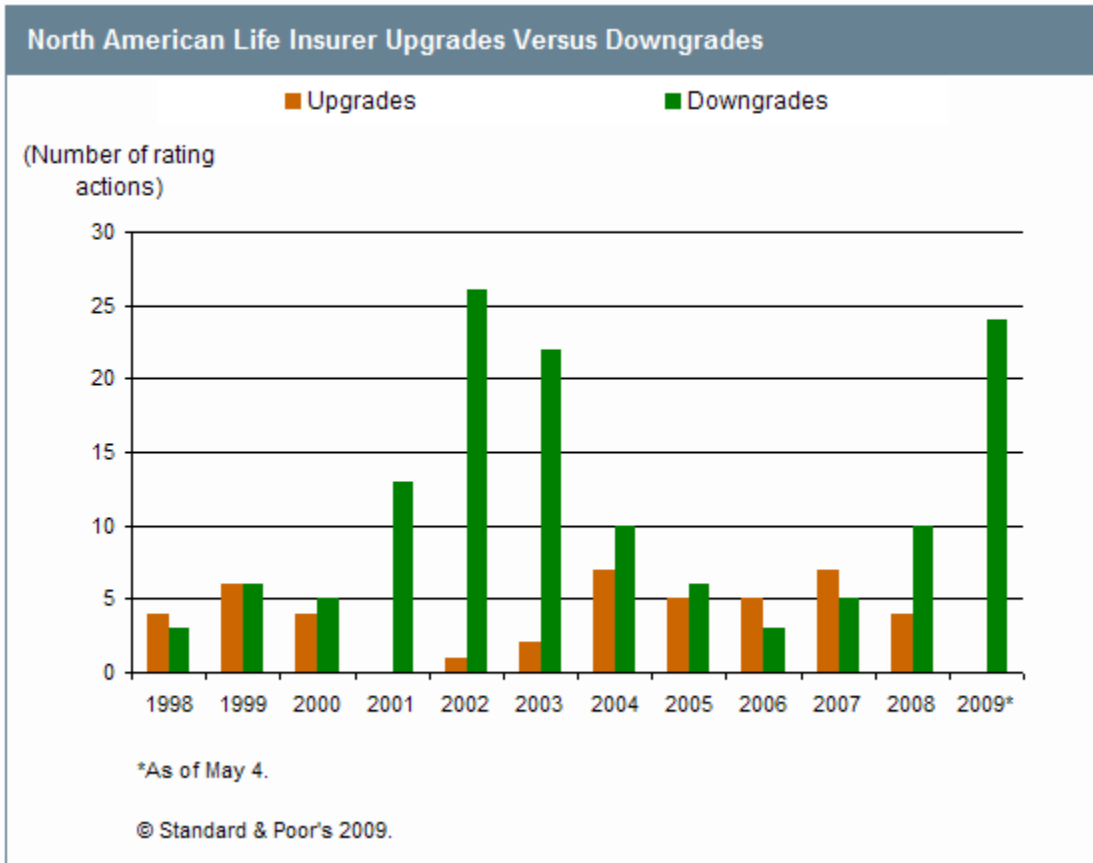


Chart 2

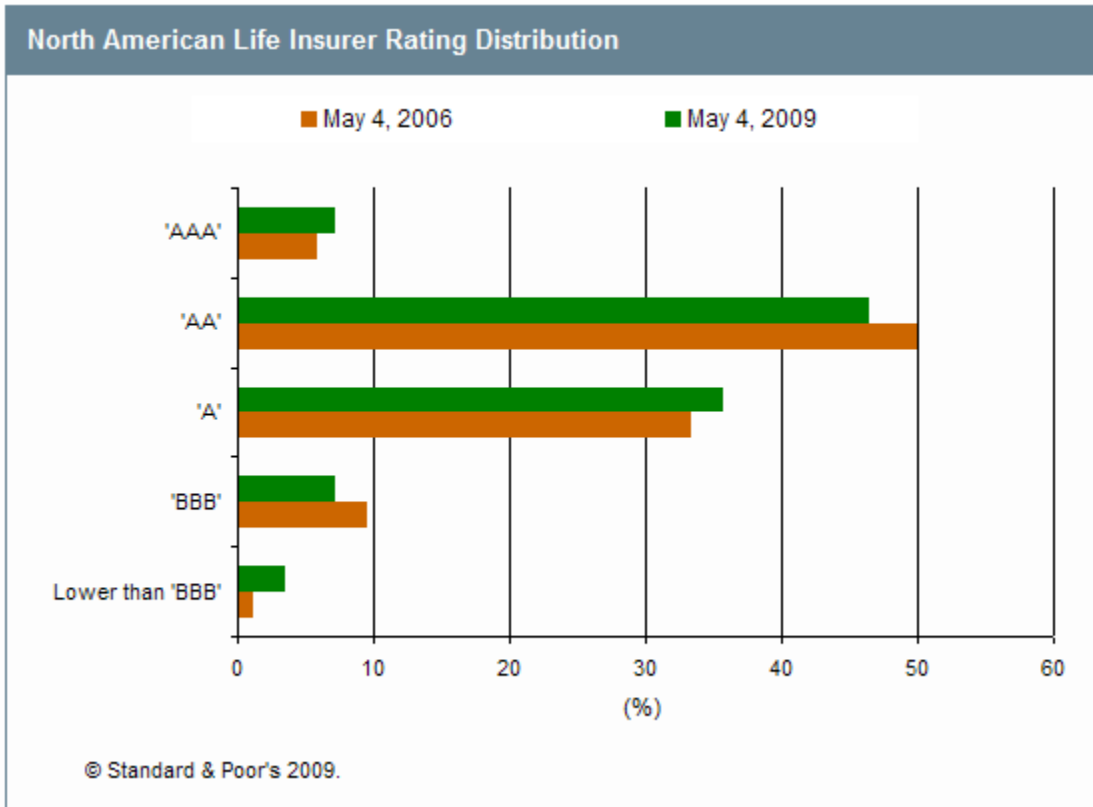
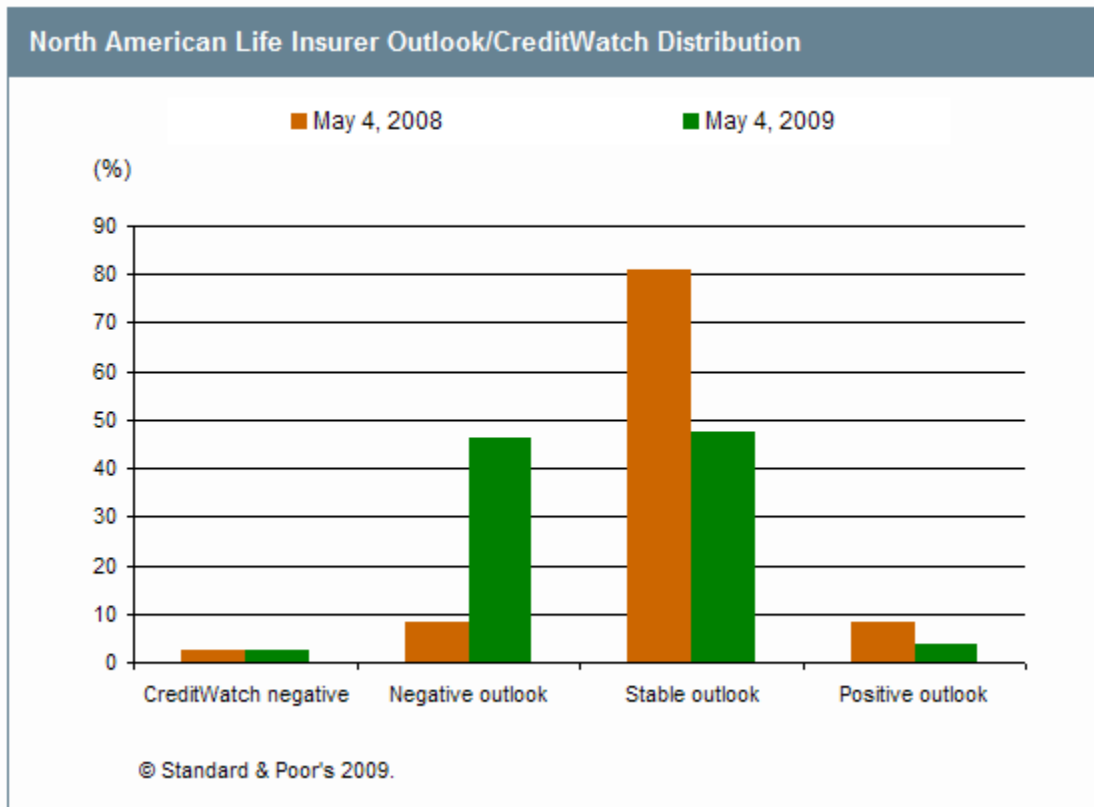


Chart 3



Asset Quality Remains A Question

Given the magnitude of this economic downturn, we believe the recession will result in higher-than-average credit losses. Life insurers' holdings of residential mortgage-backed securities hurt them at first as they recognized asset impairments and the deterioration of the underlying cash flows turned out to be greater than expected. We expect to see further underperformance across other fixed-income asset classes. Specifically, we anticipate that losses in corporate bond holdings and commercial mortgages will exceed historical averages (life insurers have traditionally been significant underwriters of mortgages for offices, multifamily housing, hotels, and other commercial buildings). These losses, though not yet material, contribute to our prospective view of capital adequacy. Higher-than-expected losses on commercial mortgages could force some insurers—including some of the largest, such as Metropolitan Life Insurance Co. (AA-/Negative/A-1+)—to seek out additional capital to maintain the particular rating.

Other insurers—such as American Family Life Assurance Co. of Columbus (AFLAC; AA-/Negative/--)—have greater concentrated exposure to the European financial sector through their holdings in subordinated, hybrid security investments. These securities have underperformed, and investment losses have affected our view of the insurer's capital adequacy.

In general, insurers have been keeping greater amounts of cash on hand to meet their obligations and maintain a desired level, even though keeping more cash than desired would also lower returns. Despite the severe economic environment, policyholder surrenders are now relatively stable and in line with actuarial assumptions. We will

continue to monitor these trends.

Equity markets appear to have rebounded from their low points earlier in 2009, which has temporarily eased some pressure on variable annuity writers. However, the cost of hedging, necessary to manage the embedded options within these products, continues to increase. With the equity market volatility index (VIX) trading at historical highs for most of 2009, hedging costs are well above what most insurers' product pricing assumes. In addition, stochastic modeling (with multiple variables) results for living benefit exposures have increased capital requirements. Further, the equity market decline has dramatically increased typically unhedged death benefit exposure, resulting in higher benefit costs.

The market for variable annuities is clearly depressed, given the decline in equity markets. Not surprisingly, in the first quarter of 2009, variable-annuity sales were off about 50% from a year earlier, reflecting the lack of interest in equity-based products amid the tumbling markets of the past year. With fewer assets under management and new sales falling, variable annuity writers are seeing reduced fee income.

On a positive note, however, individual fixed-annuity sales have been increasing. Despite a relatively low interest rate level, these products have captured the demand for minimum guarantees in the current uncertain markets. For example, in 2008, total individual annuity sales increased 3% over 2007 because of a 50% increase in fixed annuities and a corresponding decrease of 15% in variable annuities. Based on observations in the first quarter 2009, we expect these trends to continue.

Maintaining Financial Profiles Will Likely Involve Trade-Offs

Because many life insurers will not have the same access to the public markets or to institutional financing that they had before 2008, we expect that some insurers that have seen more portfolio problems than they anticipated will resort to other ways to maintain their financial profiles. Some of these options include strategic dispositions, slower business growth, participation in government funding programs, and increased use of reinsurance. In addition to financial flexibility, earning levels and volatility continue to contribute to the downward pressure on insurers' financial profiles. In recent weeks, some insurers have taken advantage of an opportunistic window that has opened within the capital markets to fortify their balance sheets. For example, Principal Financial Group Inc. (BBB+/Positive/--) recently raised \$1.15 billion in common equity and \$750 million in debt securities.

Some will sell off lines of business when this is possible. For instance, we anticipate that Genworth Financial Inc. (BBB/Negative/A-2) will likely spin off a minority interest in its Canadian mortgage insurance operations to raise funds. We expect that other insurers with little to sell or little chance of selling what they do have will need to fund debt maturities and maintain capital strength with operating-company dividends. They might also have to slow revenue growth, which would affect our view of their competitive position. Funding through the capital markets for statutory redundant reserve financing is limited, as insurers are moving back to bank letters of credit with higher costs than previous structures.

Finally, some insurers will make increasing use of reinsurance to help fund growth at a time when they do not have access to the capital they otherwise would. But with more insurers making this choice, we believe it will drive up the cost of reinsurance throughout the industry, in the face of a contracting reinsurance market, adding to life insurers' problems.

More Unwanted Attention Could Lie Ahead

The life insurance business remains among the safest of all financial enterprises—profitable, predictable, and relatively stable. The financial crisis has upended that perception and brought the industry more attention than it has seen in years. Until the recession winds down and markets rebound, our outlook on the industry will likely remain negative despite life insurers' long-standing reputation for stability.

Writer: Robert McNatt

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