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COVID-19 effect on the life-annuity sector

The below is an excerpt from the April 2020 Conning Commentary prepared by Conning's Insurance Research team.

Key Takeaways

- Excess mortality claims should be manageable for life insurers. However, reinsurers will experience more significant claims due to reinsurer concentration.
- Declining asset values coupled with the need to increase reserves pressure life insurer capital levels.
- Investment pressures will mount with the significant allocation to BBB securities facing declines in market value and likelihood of downgrades, increasing capital charges.
- Annuities will face lower premiums and Separate Account fees, coupled with significant increases in reserves and hedging costs.
- Interest rate pressures, already a challenge, will increase. New money yields will be subject to the decrease in interest rates offset by wider spreads on risk assets.

Mortality experience

At this point, the total excess mortality from COVID-19 is uncertain. Some of the features of the infectiousness and deadliness of the disease are similar to that of the H1N1 Flu pandemic of 1918-1919. Total deaths from that pandemic were about 50 million people worldwide, with about 675,000 in the United States. Given the U.S. population of 1918 was about 103 million, this represents a raw excess mortality rate of 0.66%. Given the current base mortality rate in the United States is about 0.89%, that additional amount would be a substantial rise in mortality. However, that is more of a worst-case scenario, especially because social distancing and other measures in various states may slow the spread of pandemic illness and buy time for effective cures.

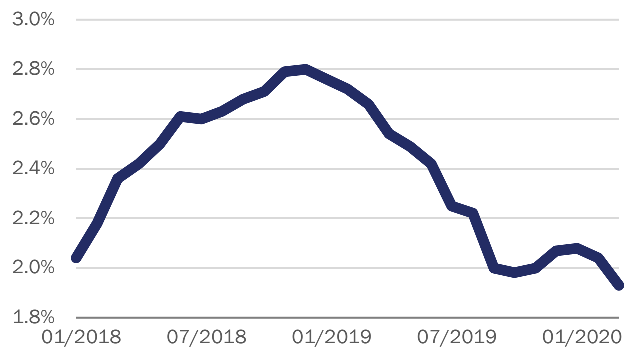
Mortality from COVID-19 is substantially higher for older people than younger people, in a much starker way than one sees in standard mortality patterns. South Korea has done extensive testing and found a 10% case fatality rate for those age 80 and older, while there was less than a 2% case fatality rate for those under the age of 70 and no deaths for those under 30. However, these are preliminary statistics, and that 10% case fatality rate is based on only 33 coronavirus deaths.

Whatever the ultimate level of U.S. deaths, the excess mortality experience for the life insurance industry overall should be manageable. Insurers will have different exposure profiles, depending on the age of each company's insured population and use of third-party reinsurance. Many direct writers had been increasing their retention limits or reinsuring with captive reinsurers. We would not be surprised to see companies with reduced use of third-party reinsurance report higher mortality. Reinsurers will experience more significant claims due to reinsurer concentration, depending on geographic footprints.

Asset decline affects capital and liabilities

The economic turmoil caused by COVID-19 has a double impact on life-annuity insurers. Declining asset values decrease capital as asset valuation reserves are drawn down. At the same time, reserves are strengthened to support in-the-money annuity guarantees, fixed annuity crediting rates, and decreased surrenders. The combined impact will lead to lower capital. This impact plays out differently based on an insurer's size, product focus, and investment strategy.

5-Year Average Multi-Year Guaranteed Annuity Crediting Rate



Prepared by Conning, Inc. Source: AnnuityRateWatch.com, accessed on March 23, 2020

Impact on annuities

When markets fall, annuity guaranteed benefits move "into the money" and insurers must increase reserves for those benefits. In addition, those annuity contracts become more valuable to the contract holder. The challenge with lower-than-expected surrenders is that, while the contracts continue to generate fees, the insurer must also maintain capital and reserves to support those contracts.

Reserve increases

Looking at 2020, we would expect to see a strong increase in reserves among annuity players, driven by equity market declines and portfolio yields. We saw this in 2008, when insurers strengthened individual annuity reserves by $72 billion, compared to just $3 billion the year before. As a reminder, the S&P 500 declined 38.5% in 2008, after a 3.5% increase in 2007.

Interest rates, and the insurer portfolio returns they help generate, also lead to higher reserve additions. When those returns are lower than expected, especially for a long period, fixed and indexed annuity reserves will need to be strengthened. Some annuity insurers with large fixed annuity blocks may need to increase their reserve contributions in 2020.

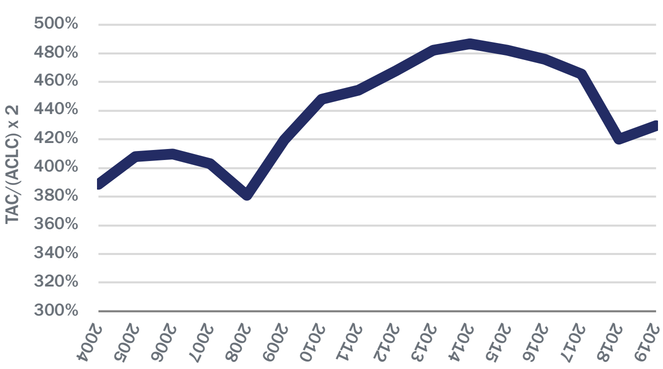
Hedging costs

In addition to the need to strengthen reserves, variable annuity insurers have instituted robust hedging programs to manage that risk. Those costs have been rising over time during the persistent low interest rate environment. Now, with the greatly increased equity market volatility, those hedging costs have skyrocketed. Policyholder behavior can also increase costs. In crisis situations, policyholders have been known to rush into "safer" asset allocations that then lead to missing out on market recoveries, adding to both guarantee and hedging costs. Given the equity market's turmoil and the pressure to keep interest rates low, 2020 is shaping up to be painful again for annuity insurers.

Capital impact for the life industry

In 2008, total adjusted capital (surplus plus AVR) fell 9%, while their ACLC (authorized control-level capital) fell just 4%. Estimated RBC for the life-annuity industry went from 403% in 2007 to 381% in 2008.

Estimated Life-Annuity RBC



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The hit to capital could have been larger, had asset valuation reserves not been approximately 12% of total adjusted capital at the end of 2007. Those reserves were in place to absorb the hit to asset values, falling to just 6% of total adjusted capital at the end of 2008.

At the end of 2019, AVR had returned to 12% of total adjusted capital. Those reserves will once again be called into play to soften the impact. What is troubling, however, is that overall RBC for the life-annuity industry has been falling since 2014.

The good news about these impacts is that, as market conditions improve, the extra reserves will be released, helping to rebuild capital levels. With 2020's turmoil, life-annuity insurers are likely to end the year with lower RBC ratios. As the economy stabilizes and improves, those ratios should recover.

Increased yield pressure leading to increased investment risk

While life insurers do not have much exposure in their General Account to equity markets, other key asset classes are also being affected due to the overall economic impacts of the pandemic. Credit spreads and credit risk shifts in the bond portfolio overall will likely challenge insurers, as life insurers increased their allocations to BBB-rated bonds from 27.2% of their bond portfolios 2010 to 34.4% in 2018.

In a wide recession, many corporate credits are at risk of downgrades, as well as defaults. Downgrades would affect RBC ratios for insurers, in turn increasing capital charges.

The current NAIC C1 risk charge for NAIC Class 2 is 1.3% for BBB-rated bonds and 4.6% for NAIC Class 3 (BB-rated) bonds. This is a 3.5x increase in the C1 risk charge, and C1 is a very large component of life RBC. For BCAR, at a 99 Value at Risk (VaR), a BBB- ten-year corporate bond has a baseline charge of 7.01%, and a BB+ is 11.99% for the same VaR and maturity.

With so many BBB-rated bonds, and a large risk charge increase if they drop one notch to BB, a small number of downgrades could lead to a large increase in capital charges.

Real estate is also a large exposure for life insurers, accounting for 18% of total investable assets. This exposure consists of commercial mortgages, mortgage-backed securities, and direct real estate holdings. This sector, encompassing office buildings, hotels, malls, restaurants, and other establishments, whose health is dependent on people actually occupying buildings, will be greatly affected by quarantine and lockdown.

Revenue effects

Life-annuity insurers will find 2020 is a year when revenue growth will be low, at best, and may decrease. Key factors in that outcome will be annuity and life insurance sales and Separate Account fees.

Annuity and pension risk transfer revenues

Equity market volatility and losses are never positives for VA sales. We would not be surprised to see VA sales decrease in 2020 and perhaps into 2021, depending on the severity and length of an equity market downturn. Efforts to stimulate the economy by lowering interest rates place pressure on fixed annuity sales as insurers lower crediting rates to match lower returns on their portfolios.

Pension risk transfers had been a growth area for several insurers, but recent market movements could jeopardize that growth. At the end of February, according to the Milliman 100 Pension Funding Index (an index of the 100 largest corporate pension plans), the funded status deficit was $347 billion, driven by the decrease in the benchmark corporate bond interest rates and by the precipitous decline in investment returns during February. Worsening funding ratios make it less likely that pension plans will purchase annuities. At the same time, lower crediting rates on those annuities increase the cost of the underlying product. Taken together, the life-annuity line may well be in for a decrease in individual and group annuity premiums in 2020.

Less impact on life revenue

Unlike annuity lines, life insurance revenues are driven far more by renewal premiums than sales. For individual life insurance, about 74% of direct premium are renewals. However, even should consumers be interested in buying life insurance at this time, sales would be difficult to complete. Full medical underwriting will likely be unavailable, as medical tests for life insurance applications will not be considered “essential.” Insurers may draw back on automated underwriting systems, as there could be anti-selection issues. Direct sales of simplified issue policies are of limited premium compared to more substantial permanent life products.

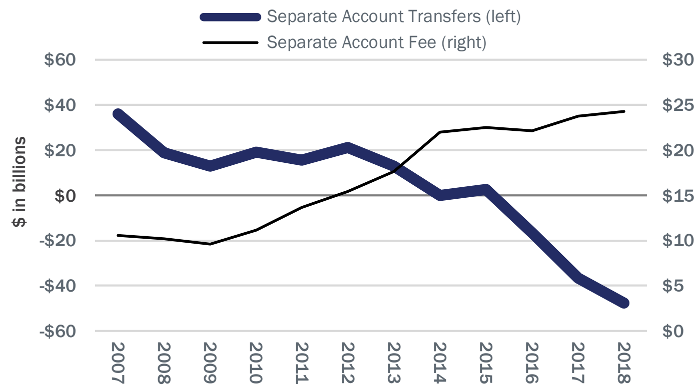
Lower Separate Account fees

With the equity markets declining, the impact on life-annuity insurers will be directly felt in the amount of asset management fees earned on Separate Accounts. While Separate Account fees represent just 4% of total revenue for the life-annuity industry, it was 10% for the individual annuity line and 21% for the variable annuity product.

Separate Account fees are likely to decrease in dollar terms if equity markets remain depressed. This decrease would be driven by the combination of lower Separate Account balances as well as negative Separate Account net transfers.

During the previous economic crisis, individual annuity Separate Account fees decreased 13% from $10.6 billion in 2007 to $9.6 billion in 2009.

Separate Account Fees and Net Transfers



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