



The Forecaster

Positioning the Industry for Success



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Many factors contributed to a prosperous life insurance market during much of the last decade. Companies were introducing new product features at competitive prices. Capital market financing was available at low rates. And companies, buoyed by appreciable sales growth, low capital costs and robust investment earnings, reported record profits. But this prosperity was challenged severely by the financial crisis.

Paul Rutledge, President of Transamerica Reinsurance, recently had a conversation with Fred Sievert, former president of New York Life and current chairman of the Actuarial Foundation, about the demanding issues facing life insurers since the onset of the financial crisis. Fred shares his view that a number of life insurers, in search of continued growth, became too comfortable with optimistic investment gains subsidizing increasingly risky business. When the financial markets began failing, the weaknesses of this dependency were exposed.

Fred retired in 2007 as President of New York Life, where he held a number of senior positions. Before joining New York Life, Fred was an executive with Royal Maccabees Life Insurance Company in Southfield, Michigan. Fred is a Fellow of the Society of Actuaries and Member of the American Academy of Actuaries. He holds a B.A. degree from Amherst College and an M.A. from Wayne State University. He is currently pursuing a graduate degree from Yale Divinity School.

Paul Rutledge: Thank you for sharing some thoughts on what's going on in the industry these days. As a former president of New York Life, you obviously know the business, understand the mechanics, and you stay involved in the actuarial profession. But you also have the benefit of distance from the day-to-day running of an insurance company, which gives you a perspective that can be helpful here.

Fred Sievert: Yes, a little distance helps. I've been able to look at our industry from a different angle since I've retired. For example, I'm in a class at Yale that Tony Blair teaches called "Faith in Globalization." It's about how different faith traditions interact with globalization and the impact this has on the cultures and the expansion of business worldwide. Some of the case studies are quite pertinent and cause me to think about things that have occurred in our industry and lessons we can learn.

PR: The financial crisis certainly put our industry to the test. How do you think we performed compared to other sectors of financial services?

FS: It probably goes without saying at this point, but one area where the industry did poorly – though not as poorly as some other industries – is the whole area of risk assessment, risk management and risk mitigation. When you look at the investment side in particular, there was an inadequate level of scrutiny and understanding of the underlying risk on the asset side of the balance sheet. I haven't seen recent analysis of the write-downs and losses that occurred, but I don't think there's any question that investors should have seen through the problems with some of the mortgage backed securities and CDOs. I mean, primary lenders were doing little if any underwriting; they were passing on the risk to investors through securitization. Companies should have seen the risk exposures in these assets.

But a lot can be learned from what's happened. Companies that had chief risk officers who really, significantly analyzed the enterprise risk, made sure it was reviewed by the top executive team and reported to the board probably did better in terms of write-downs and losses.

PR: I think the mutual structure allows a longer term view of the market. They don't have the same quarterly pressure for top and bottom-line performance. I see a distinct differential between how mutuals approach risk and adapt the business model versus a stock company.

FS: I think that's true. An aspect of this difference can be seen in the portfolio mix – where stock companies tend to have less equity risk exposure than mutuals because equities are more sensitive to short-term volatility. So when the market dropped 30 percent at the height of the financial crisis, a lot of the stock companies felt it less. It may not have been a conscious strategy to protect against volatility, but it ended up helping them out. On the other hand, I think more of the stock companies were willing to take some credit risk that mutuals perhaps were more cautious about. When credit spreads got down to single-digit basis points on some of this stuff, mutuals were probably more likely to decide it wasn't worth the risk to gain a few extra basis points by lowering quality or by taking asset-liability mismatch risk. But despite differing investment strategies, both types of companies had sizeable investment losses.

Balancing Growth and Risk

PR: Over the last 20 years the product mix has shifted to complex guarantees as insurers differentiated themselves from other financial services. This encouraged companies to take on new unknown risks to get the growth. It seems every 10 or 15 years the industry incurs a crisis of one form or another. Does the industry have the fortitude to find a healthy balance between the drive for growth and risk management?

FS: You're right about the cyclical occurrence of these crises. Several years ago

we went through one with the disability business where everybody was out to meet the competition, and they didn't appropriately analyze the risks and the reserves that were required.

More recently, companies under-priced guarantees and really went after growth and market share with very little assessment of the potential scenarios that could emerge.

With product guarantees, companies need to perform a very difficult balancing act. If you do everything properly – provide the guarantee, price it fairly, reserve for it, mitigate the risk – you risk pricing yourself out of the market. When you have a thousand companies out there, not every one is going to exercise the same level of financial prudence. At New York Life we felt that guarantees were very important, but we wouldn't go too far with them.

I think a lot of the problems in the industry boil down to an aggressive pursuit of growth. You do get significant pressure on growth when you have a lot of fixed costs, a lot of overhead coupled with a capital intensive new business financing situation. The problem is that at some point you run the risk of under-pricing products and taking on too much risk. Often the consequence of so much focus on growth is a hunger for yield on the investment side, and we see where that got us.

Maintaining balance between the drive for growth and risk management is extremely difficult but it's something companies will just have to do. Growth can't be the primary objective. Making sure growth is profitable will be extremely important going forward, even if it means a diminution of sales.

PR: It's very hard for someone who has accountability not only to policyholders but to shareholders to go out in front of everybody and say, "We're not going to grow for the next two years because it doesn't make any sense."

FS: You're really making the argument that we made for years about why we remained a mutual. Back in the mid-1990s, everybody – the rating agencies, the consulting companies, our advisors –

everybody was asking why we seriously hadn't considered demutualization. We held firm because we think there's an inherent conflict in trying to satisfy shareholders at the same time you're trying to satisfy policyholders.

PR: It's a challenge, and I think the mark-to-market accounting makes it worse.

FS: I agree. We've already seen this year how mark-to-market can affect reporting.

Accounting, Regulation and Alignment

PR: As a mutual, you can do mutual GAAP accounting for business line management but still really focus on statutory and book-value accounting for reporting purposes. Stock companies, on the other hand, have moved to IFRS accounting with mark-to-market and some fair value requirements.

FS: I don't know about the smaller mutuals, but New York Life and some of the other large mutuals definitely focused on GAAP prior to the financial crisis. We started producing regular GAAP statements in the mid-1990s, and it really became the focus at the executive management and board level. A good number of mutuals appreciate GAAP and what it can tell them about a business line's performance beyond what the stat numbers tell them. I'm guessing the financial crisis has led other mutuals to move to focusing more on GAAP numbers, too.

New York Life has also been very involved in what's happening internationally on accounting standards. I remember about three years ago I had to stand in for our CFO at a meeting – it was an ACLI meeting in conjunction with the boards of the IASB and FASB – when they were talking about mark-to-market accounting. Now I hadn't spent much time on this, so I got a two-hour briefing from my staff before the meeting. I was there with about 12-15 other industry executives who were involved in this. And to my surprise, few knew much more than I did about what was happening in that arena. A lot of people from the industry – even stock company representatives – didn't really know what was happening. I'm sure that's changing. I think all companies are looking at accounting issues and the challenges that they

might pose. Certainly the financial crisis has raised this awareness. It brought some of the concerns companies had about mark-to-market from theory into reality.

PR: I think the industry in general needs better alignment. We need governing policies that work together and line up with the value proposition in our products. I'm afraid we have various disassociated polices starting to take place – accounting, regulatory, state versus federal oversight.

FS: There are a lot of competing forces out there. I understand the Optional Federal Charter is on the back burner now because of all the other activity going on. At New York Life many of us had mixed views on the Optional Federal Charter versus state regulation. We felt we had really done extraordinarily well in building relationships with the states. There are certain states that have a very good handle on what's happening and others that lack the resources or talent to really make a difference. And, of course, it's a very expensive and time consuming process.

I don't have a lot of faith personally in the federal government regulating anything. All you've got to do is look at the SEC and Madoff to come to that conclusion. I don't know how they could regulate and effectively oversee a business as complicated as the insurance industry.

PR: It seems the industry has equated complexity and innovation in recent years. Do you think product innovation and simplicity are mutually exclusive?

FS: That's a very good question. Simplicity and innovation are not mutually exclusive. In fact, I think simplicity is the key to future product development and design success. Two experiences at New York Life come to mind. We had a single-premium immediate annuity product that we felt met an untapped need but for some reason wasn't selling. We did some pretty thorough research to figure out the consumer and producer objections to the product. And what we discovered wasn't rocket science. For example, we found out that "SPIA" is not a good marketing

An upcoming issue of The Forecaster will feature an interview with a retired executive from a stock company.

term. Imagine that! We also identified some benefit features that consumers needed: an inflation index, some death benefit and liquidity features. And we changed the compensation structure. We went from around number 10 in the market to number one.

We also had a customizable whole life product that was very innovative, though some would look at it and say it was “back to basics.” It gave the consumers a lot of latitude to design the product around their needs, which sounds complicated but it was made very, very simple for the agent and the consumer. I actually bought this product for each of my granddaughters after they were born. The product isn’t guaranteed – it couldn’t be – but it is illustrated on a conservative basis. I was able to customize the policies so that I pay premiums for a fixed period, then later in the life of the policy funds are released to help with major life events. It even can be designed to provide retirement income. It’s actually a very simple product design that has a very complex system behind it.

PR: Obviously you’ve designed a product here with tremendous customer value that’s easy for the customer to identify. Do you think recent economic events will lead to better product design – in terms of both managing risk and doing what’s right by the customer?

FS: Yes, I actually think product design will improve going forward – to the benefit of life insurers and policyholders. I expect to see some pretty significant changes in the industry, and in many respects this will involve getting back to the fundamentals of our business.

Look, financial security is more important than it has been for quite a while. People aren’t looking for the next big investment deal. They’re looking for assurance that their money will be there when they need it. Helping people manage their financial security – what a wonderful message this should be for the life insurance industry!

Companies need to be talking about the security that the guarantees of our most basic products offer. That’s what we did at New York Life with our SPIA, and that’s why we’re a key player in that market. That’s the same message we deliver when we talk about permanent insurance – the security of lifetime coverage, of secure savings – and of an asset that never loses value. The need is there. We just need to do a better job in explaining to the customer how we’re the best to help them meet those needs.



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