The Life Insurance Industry in Mid-1993

By Francis H. Schott*

The life insurance industry participated in the aggressive and risky financial activities of the 1980s to a far lesser extent than depository institutions while adapting its products and investments to a yield-conscious and short-term oriented environment with reasonable success. Nevertheless, a few spectacular failures in 1991 and the lingering recession have caused a sharp turn toward conservatism in life insurance management and regulation.

INSTABILITY and unusual risk-taking virtually define the history of U.S. institutional finance of the 1980s. In reaction, the 1990s as a whole are likely to be characterized by a return to conservatism in management and regulation of such institutions, developments clearly evident in the early part of the decade.

The life insurance industry, part of an increasingly intracompetitive universe of financial institutions, has participated in both the slide toward instability of the 1980s and in the retreat toward caution of the 1990s, but in a greatly attenuated manner compared with depository institutions. The pressure on capital ratios and the increase in portfolio difficulties and in the volatility of liabilities have been less pronounced than in commercial banking and far less among the thrifts. Insurance company failures have remained fairly isolated and have involved small percentages of numbers or assets of the universe of companies.

Nevertheless, perceived stress is high among industry management and analysts, while the general public is somewhat apprehensive. A dichotomy exists between reality and perception. One reason is the difficulty of curing quickly the portfolio problems of a long-term lender, which certainly applies to the insurance industry's commercial real estate investments. Another reason is structural stress on the industry arising from the clash between an increasingly investment-performance-oriented financial environment and the traditionally high-cost insurance distribution system. Finally and ironically, the intensive attention devoted to the finances of the industry by regulators and rating agencies itself contributes to stress.

LIFE INSURANCE EVOLUTION DURING THE 1980s

The industry more than held its own against other institutions during the high-flying 1980s, whether the measurement is asset growth, funds supplied in the capital markets, or share of the consumer dollar obtained. Thus, the industry was ahead of the commercial banks and the thrifts in net funds supplied to the capital markets in 1991, whereas it had lagged far behind a decade earlier. The ratio of premiums and annuity considerations relative to disposable personal income (DPI) actually rose from 3.24 percent in 1980 to 5.07 percent in 1990, a post-World War II high. In addition, the number of insurance companies (over 2,100 in 1991) was larger than a decade earlier, although down somewhat from the 1988 peak.[1]

This record reflects major changes in response to the market pressures of the 1980s. The key components of the adaptation were a sharply rising share of accumulation (as against protection) products on the sales side, and a corresponding diversification into specialized-product matching on the investment side.

In the course of the major inflation of the late 1970s

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[1] See footnotes at end of text.

and early 1980s, traditional whole-life policies turned out to be costly to the insured. Long investment maturities did not permit escalation of policyholder crediting rates in line with that of interest rates. Besides, spreads between earnings rates on investments and crediting rates were high as long as life insurance was sold primarily as a protection device.

Faced with a sharp turn toward term insurance and with policy loan drains and liquidity squeezes, the industry developed a class of policies that provides for the flowthrough of current investment results to the policyholder inside an insurance wrapper. They frequently permit investment choice on the part of the insured and flexibility as to premium input while maintaining mortality protection. Depending on their specific characteristics, these policies go under such names as variable life, universal life and variable/universal life. These policies now represent about one-third of all life insurance in force.

Even more crucial in maintaining the flow of funds to the industry was the increased emphasis on pension and annuity business. The industry widened its role in 401-K (employee savings) plans while holding its shares in the individual retirement (IRA) and small-business (Keogh) pension plan markets. Most strikingly, by the mid-1980s the industry's offerings of tax-deferred individual annuities, with investment choices similar to those previously available only to corporations, pushed annuity considerations to the point of outpacing insurance premiums as a source of revenue.

These product developments sharply altered the investment climate within life insurance companies. The variety of investment vehicles that had to be made available to corporate and individual clients forced additional separate accounts for equities, money-market instruments, bonds and real estate into the overall portfolio. The higher growth rate of such flowthrough accounts compared to company general accounts has shifted more investment risk to clients but has also forced investment performance into the forefront of competitive considerations.

In the general accounts of insurance companies, a fundamental shift in the direction of shorter-term maturities and more liquid instruments became necessary. The average maturity of bond and mortgage holding was cut roughly in half, to about ten years, in the span of a decade, as asset/liability matching became a key concept of proper management. Among corporate bonds, public rather than privately placed bonds became the rule, and U.S. government and agency securities became a significant part of life insurance portfolios for the first time since World War II. Hedging through futures and options was explored to cope with interest-rate volatility and liability-withdrawal potential.

PRESSURE POINTS

Transformation on the scale of the past decade has challenged life insurance industry traditions and brought new problems. In spite of the generic nature of the difficulties, company failures have remained isolated.

The high distribution cost of the industry is related to the old saw that "life insurance is sold, not bought." Whatever its validity for the original product, however, the maxim does not apply to the ever-more-explicit savings/investment component of annuities and revamped insurance policies. In competing, in effect, with the brokerage industry and with savings through depository institutions, the industry has struggled to find new compensation schemes for agents used to getting 50 to 55 percent of the first-year premium. One possible and widely used compromise is to pay a reduced front-end commission for investment products, put 100 cents of the dollar of the client's money into his account and seek to recoup the commission over time through investment management fees. This requires carefully calculated "back-end" charges to curb early withdrawals, but financial protection against all possible adverse scenarios is almost impossible to secure.

The cost problem of course extends to home office personnel. Indeed, the pressure on operating margins is the most striking — and most likely genuinely structural — problem to have surfaced as the consequence of the 1980s. Industry employment has been roughly static since 1987 at about 2.1 million in spite of huge sales and balance sheet increases. "Forced" productivity gains have become widespread throughout the U.S. economy and can be painful to those directly concerned.

A second pressure point has been the industry's sudden exposure to the mainstream of yield competition within financial markets. Growth through investment promises to clients in a rate-deregulated environment became a competitive vehicle. All major companies keep close track of annuity and guaranteed interest contract (GIC) rates quoted by their peers. Sophisticated customers, such as corporate treasurers negotiating on behalf of employee savings plans, exerted never-before-known customer clout upon life insurance management.

It follows directly that investment performance became a third pressure point. Asset results had to justify liability promises. Thus, in a normal yield curve environment, an asset/liability mismatch may help offset GIC guarantees (e.g., ten-year investments vs. rate guarantees based on a five-year maturity of the GIC contract.) Similarly, an upward move on the risk/reward curve may, if successful, restore profit margins bargained away in getting annuity money. By the late

1980s, the deal-making frenzy of leverage buy out and merger and acquisition activities made such ventures especially tempting.

The commercial mortgage holdings of the industry, which have turned out to be a fourth pressure point, fall into a separate category: Life insurance managements were caught in a general market problem over which they had minimal direct influence. Mortgage holdings actually declined drastically as a share of life insurance investments between the late 1970s and the early 1990s (from 27 percent in 1980 to under 15 percent in 1991). Equity real estate remained at around 3 percent of holdings.

It is true, of course, that the industry participated in commercial real estate at market-dictated loan values, which were propelled upward by the liberalization of real estate taxation and of savings and loan portfolio regulations in the early 1980s. The prolonged recession in commercial real estate since roughly 1988 is the most significant single problem contributing to financial strain in the industry in the early 1990s. High vacancy rates in downtown office buildings and low occupancy rates in major hotel/motel chains are prime explanations of fifty-year highs in mortgage delinquencies. The peak rate of delinquencies for all types of properties combined, was reached in early 1992, at around 7.5 percent of holdings, and has since receded.[2] (Peak rates for hotel/motel loans were around 15 percent and for office buildings around 9 percent, and all these peaks also occurred in early 1992.)

Additional difficulties occurred for a few large companies that went considerably beyond the industry average in equity real estate. Such holdings often took the form of joint ventures where the life company obtained "a piece of the action" in return for providing the long-term financing. When joint-venture partners (typically developers) ran into financial problems, life companies had to become owners of up to 100 percent of the real estate in attempting to salvage their original investment.[3]

THE FALLOUT AND THE REACTION

As noted, life insurance failures have been spotty and small relative to the size of the industry. Seventy failures in the five years ended in 1989 in the aggregate affected only 1 percent of industry assets (as of the end of the period). An industry-sponsored study of these failures found outright fraud or gross management mistakes responsible for a least half of these (relatively minor) failures.[4]

In the single year 1991, however, four large companies (six, counting affiliates) failed or had to be taken over by state insurance departments, and these companies accounted for about 3 percent of the industry's assets. The two largest of these companies have become household words — Executive Life (of California and New York) and Mutual Benefit Life (New Jersey). Since 1991, through mid-1993, there have been no large additional failures.

It has been noted that "the insolvencies of 1991. . .were directly related to investment problems arising from over-investment in 'junk bonds'. . .and default on commercial real estate mortgage loans leading to sizable book losses."[5] More specifically, Executive Life was known to have about 50 percent of its assets in junk bonds while Mutual Benefit had 50 percent of its assets in mortgages, with a heavy concentration in a very small region of Florida.[6]

The failure of such "outliers" appears to have caused disproportionately intense reactions among the public, legislators, regulators and rating agencies. Why such strong reactions?

First and foremost, the life insurance industry lacks a general insurance scheme of its own. Failures tend to affect the individual customer more severely than do depository institution closures when the FDIC steps in. To be sure, the network of state guaranty funds has in very recent years finally been extended to all fifty states. Because there are no accumulations in these funds, however, the post-incident activation of a guaranty fund involves the gradual collection of assessments from the insurance companies operating in a state. In practice, the process is so difficult and protracted that insurance regulators have preferred to negotiate for the takeover of the liabilities of a failed company by financially stronger competitors. The typical outcome has been that only death claims are paid in full while annuitants and corporate creditors must eventually accept some reduction of previously promised benefits. Both the delays and the give-ups sensitize the public to any further suspected insurance industry problem.

A second reason for the strong public reaction to insurance failures is the role of state regulators, whose possible mistakes lend themselves to politicization of the issue. Throughout the go-go atmosphere of the 1980s, insurance commissioners were aware that some insurance managements might be affected. Led by the traditionally strictest New York State Insurance Department, they reversed the deregulatory ambiance of the early 1980s, but only gradually. Two important steps were a stiffened curb on junk bonds (1987, further strengthened in 1991), and a clever actuarial/financial test of projected cash flow adequacy ("Rule 126," 1985).[7] State supervision of insurance proved superior to federal regulation of depository institutions, but (unsurprisingly) fell short of perfection.

Third, the industry became exposed for the first time in history to widely available commercial rating agency scrutiny. This very fact has the potential for aggravating public reaction to any actual or perceived problem. Sensing a market opportunity, Standard & Poor's, Moody's and Duff & Phelps began to rate insurance companies roughly simultaneously in the mid-1980's. (The only traditional rating service, A.M Best's, conferred generally high ratings.)

These services have brought expert financial analysis to an industry previously judged mainly by actuarial and regulatory criteria. However, after being caught in greatly belated recognition of the problems of the 1991 failures, the rating agencies turned sharply conservative and have engaged in repeated and broad downgradings. (Commercial real estate mortgages have been the most common reason for downgrades in the past three years, especially after the junk bond market began to improve in 1991-92.)

Unlike a longstanding risk-rating scheme used by state regulators, the rating agencies' classifications (and their changes) are almost instantly known to the press and hence the public. (The field forces of the most highly rated companies see to such client education!) Because the fallout from repeated downgrades may result not only in the loss of sales but also in a "run on the bank," the rating agencies have become a key influence on the industry in the span of just half a decade.

TURN TO CONSERVATISM

The early 1990s and especially 1992-93 have been characterized by a scramble toward conservatism on the part of life insurance management, regulators and rating agencies. There is an element of "fighting the last war" in this scramble. In addition, no current measures can immediately obviate the pressure points of the 1980s just enumerated. Furthermore, risk aversion has societal costs along with the benefits.

Life company investment acquisitions in 1991-92 were almost entirely focused on government and agency securities (including a substantial amount of federal agency guaranteed mortgage-backed securities), plus investment-grade public corporate bonds. Direct-placement bonds and commercial mortgages were less than 5 percent each of new acquisitions in these two years, as against 15 to 20 percent each a decade earlier.[8]

Management also proved ready to adjust downward crediting rates on interest-sensitive products in a declining interest-rate environment. GIC contracts outstanding have declined since 1989, and their terms have been adjusted to reduce carrier risk. Investment "flowthrough" products are being favored in sales efforts. Dividends on mutual products have been cut and "lifetime employment" for experienced personnel is no longer an industry norm.

Capital ratios for the industry as a whole, i.e., the ratio of capital to assets, remained in the 8.5 - 9.5 percent range without a discernible downward trend for the entire period 1980-91. Industry observers have argued, however, that risk-adjusted capital has been declining because of the increased volatility of the industry's balance sheet since the late 1970s.[9] Insurance managements are responding by raising retained earnings and by a likely wave of demutualization to gain access to external capital. Mutual companies, which account for only 5 percent of the number of companies but for more than 40 percent of the assets of the industry, have been precluded from the equity markets and almost totally so from the debt markets, yet have had capital ratios at the lower end of the entire range of companies. (These ratios, however, have tended to be negatively correlated with size, not with a company's organizational form; mutual companies still account for seven of the ten largest companies.)

These measures — virtually forced upon many companies by the need to attain or retain high ratings — are also closely related to regulatory initiatives that, taken as a whole, will amount to the tightest supervision the industry has ever known. As a part of strengthened enforcement, the regulators have established new standards for themselves — an accrediting mechanism for state insurance departments and an agreed-upon obligation to pursue fifty-state enactment of National Association of Insurance Commissioners (NAIC) model laws and regulations.

The regulatory initiatives include a "risk-based capital" (RBC) requirement effective by year-end 1993; an asset valuation reserve (AVR) and an interest maintenance (IMR) requirement, both effective since the beginning of 1993; and a model investment law likely to become effective in 1994.

The new AVR will extend the previously effective mandatory securities valuation reserve (MSVR) beyond securities to cover real estate as well. If a stabilization reserve for asset-value fluctuations is appropriate, it is clear that the treatment of mortgages and equity real estate should be similar to that for stocks and bonds. The IMR is a parallel device to stabilize the flow to the bottom line of the asset valuation consequences of interest-rate fluctuations. (In effect, interest-fluctuation-caused asset valuation changes have to be amortized over a period of years rather than to be booked as they occur.) The AVR and IMR may help the industry cope with the Spring 1993 adoption of market valuation of assets in financial statements, as decreed by the Financial Accounting Standards Board (FASB) over the strong objections of the industry.

The Model Investment Law seeks to codify much that has been learned (and often regulated *ad hoc*) regarding risks acceptable to the regulators of insurance portfolios. Thus, it will state explicit upper limits of various asset classes, and it will refine these limits of securities by investment grade. Defining permitted types and degrees of use of derivatives has turned out to be a divisive issue in getting to a final version of the law. (The principle to be followed will in all likelihood remain that of allowing only hedging through derivatives, and not the assumption of risk by taking a long or a short position. The devil lies in the details.)

Risk-based capital (RBC) is getting especially close scrutiny by industry observers as implementation approaches. There is an (approximately) ten-year history of the formulation of appropriate capital standards: The industry itself, regulators and rating agencies all have struggled toward a reasonably rational and broadly acceptable formula. The result bears a family resemblance to the "Basel Agreement" capital standards for commercial banks. (Comparisons of the relative severity of the standards are difficult and so far inconclusive.) Because no one could prove an existing capital deficiency for the life insurance industry as a whole, the aggregate result is estimated to be that life companies hold capital equivalent to about 120 percent of the RBC standard, but actual figures must await the accounting data for the end of 1993, the first year of RBC effectiveness.

Four risks with differing capital requirements are distinguished — asset risk (investment default); insurance risk (mortality); interest rate risk (essentially duration mismatch between assets and liabilities); and, finally, business risk (a catchall that includes exposure to state guaranty fund calls as well as management errors not covered in the specifically enumerated risks).[10]

The calculations are enormously complex, but one clear principle is that diversification is judged to reduce risks and capital requirements. Thus, while for large companies investment risk is the major element in calling for capital, its impact can be attenuated by adding to numbers of debtors (and, of course, to rated quality of investments). Similarly, the insurance risk is deemed to decline with diversification among product lines, which is positively correlated with company size. Thus there is, in the end, a simulation of what constitutes a currently well-run company, including the notion that risk declines with size. The penalties for noncompliance with RBC standards are severe, but a company cannot expect to continue operating without meeting the RBC standard anyway. (More likely, companies will have to exceed the standard in order to get ratings permitting them to stay in business.)

The industry is rolling with the punches of tightened regulation, but three objections have surfaced and will be heard increasingly. The first one is that the various measures described have not been developed as, and are not, a coherent whole. Inconsistencies between, e.g., RBC standards and the proposed Model Investment Law, are emerging. Second, the prescriptions have a spurious accuracy about them and necessarily reflect the now-recognized pressures of the 1980s rather than the unknown problems of the 1990s. Third, the combination of company and regulatory conservatism has most likely contributed to the rise in credit standards amounting, in the view of many, to a credit crunch in the 1990s. In turn, stricter credit norms may have contributed to the slowness of the recovery from the 1990-91 recession in 1992-93.

By mid-1993 it has become clear that the swings of the pendulum take time. Conservatism is having its day and will have to run its course.

REMAINING ISSUES

The pressure points of the 1980s are slowly easing, but several issues remain. Operating margins in the insurance business have improved since 1991, but reforms in field-force compensation remain difficult to accomplish. A strong management drive is under way to pay commissions gradually and to link them to persistence, as against the traditional first-year (and nearly final) commission. The aims are to give the agents more of a stake in keeping their business on the books and to reduce the capital strain on the company arising from field force sales success. Agents have accepted reduced commissions on annuity business, as noted. They may increasingly turn to fee-based financial counseling, especially because an ever-increasing percentage of agents is passing the SEC exams for securities-sale qualification.

Insurance company management is taking advantage of the current mutual-fund sales boom by broadening the investment options available under the insurance and annuity umbrellas, and by affiliating with, or actually acquiring, money management firms and/or mutual fund complexes. Naturally, the clash of insurance and brokerage "cultures" is a difficulty.

The industry would benefit greatly from a central liquidity source. It is true that the turbulence of the late 1970s and of the 1980s was surmounted without such support. Yet, the credit problems of the early 1990s have affected the industry not only as a lender but also as a borrower. Commercial bank credit lines have occasionally been difficult to obtain even for well-run companies. Continuing aversion to federal regulation by the industry and by the states alike probably precludes a trade-off such that a federal liquidity source would go with federal regulation. (Even as matters stand, the Federal Reserve can lend to an insurance company in an emergency.)

Demutualization, while certain to continue, has turned out to be agonizingly difficult and expensive to accomplish. State regulators have gone all-out to secure probity of management and equity among policyholders throughout the process. The net cost of capital to the significant sector of the industry contemplating conversion is almost certain to be very high compared with that cost to existing stock companies within and outside the industry.

Eventually, the new management and regulatory conservatism will have to be succeeded by a more balanced approach. Life insurance has played a vital role in financing the intermediate-risk sector of capital users (e.g., in putting the airlines' jet fleet and the shopping mall on the U.S. economic map). This social role for the industry is an asset to the U.S. economy over and above the meeting of needs through insurance protection and savings through insurance. Management discretion, including a degree of risk-taking, is essential in attracting talent and capital to any business.

FOOTNOTES

[1] The basic data used in this paper come from the American Council of Life Insurance (ACLI) *1992 Life Insurance Fact Book*, Washington, D.C., 1992 (and earlier editions). The Federal Reserve Board's flow of funds, published periodically in the Board of Governor's monthly *Federal Reserve Bulletin* is a good source of data for comparative institutional finance.

[2] Nathaniel B. Cabanilla, "Commercial Mortgages in the Portfolios of Life Insurance Companies," Investment Research Department of the ACLI, Washington, D.C., Dec. 1991 is a key source of information, which can be supplemented with periodic ACLI reports on the industry's mortgages.

[3] Relationships with corporate pension clients that had invested in equity real estate through commingled or individual separate accounts proved to be yet another difficult problem for the few (but very large) life companies that had engaged in such operations. Withdrawals from such accounts had typically been contractually limited because of the illiquidity of real estate. Nevertheless, the "waiting lines" that developed when corporate clients sought to "get out" in the early 1990s was a serious image problem for "blue-chip" life companies.

[4] "Report of the ACLI Task Force on Solvency Concerns," ACLI, Washington, D.C., September 1990.

[5] Kenneth M. Wright, "The Life Insurance Industry in the United States," *Working Papers* (WPS 857), World Bank, Washington, DC, 1992, p. 30.

[6] Sample of readings available on these major failures: Gary Schulte, *The Fall of First Executive*, Harper Business, 1991; Samuel F. Fortunato and Victor H. Palmieri, "Interim Report Regarding the Rehabilitation of the Mutual Benefit Life Insurance Company," (Submitted to Superior Court of New Jersey, Trenton, NJ), Mutual Benefit Life, Newark, NJ, Feb. 1992.

[7] The test requires a company's "valuation actuary" to certify that the cash flow from the assets underlying each defined bloc of business (whole life, individual annuities, ect.) is adequate to meet the cash outflows arising from these insurance liabilities, period by period, and under widely differing economic and interest rate scenarios. An "unqualified" actuarial opinion regarding this test may be worth a "rating grade" on the part of the commercial rating agencies. (The concept and role of a valuation actuary itself dates only from the early 1980s.)

[8] "Recent Developments in the Market for Privately Placed Debt," *Federal Reserve Bulletin* Vol. 79, #2, Feb. 1993, pp. 77-92, traces the decline in life insurance involvement in the direct-placement market as a part of the Board's studies of the "credit crunch" of the early 1990s. A helpful source for the evolution of commercial real estate and of life insurance's role is Leonard Sahling, "Commercial Real Estate in the '90s: Half-Full or Half-Empty," Merrill Lynch *Insurance Executive Review*, Vol. 1, #1, Fall 1992.

[9] A strong argument along these lines has been advanced by Robert Hogue, FSA, in "Risk-Based Capital for Life and Health Insurance Companies," *Firemark Insurance Perspectives*, Parsippany, NJ, March 1992. Both Hogue and Wright (*op. cit.*, p. 34) point out that the capital ratios have declined by about two percentage points since the early 1980s if Mandatory Securities Valuation Reserves (MSVR) are excluded from the calculation. One may argue that such reserves, in effect, stand before capital and surplus (a valid extra cushion); or one may argue that the absolute and relative increase in MSVR itself points to increased problems (and need for capital).

[10] A cottage industry engaged in exegesis of the RBC standards (and related measures) has sprung up. (The article by Hogue, cited in footnote 9, is one example. Another one is "Risk-Based Capital for Life Insurers," by Morgan Stanley, New York, Jan. 1993.) One may, for example, calculate break-even points between higher and lower-yielding investments, given their differing capital requirements. This calculation has to be constrained by outright limits on low-rated investments in the current investment regulations and/or the future Model Investment Law.

Note: Additional references are available from the author on request at 311 Cantrell Road, Ridgewood, NJ 07450.