On August 9, 2011, SCOR SE, a global reinsurer with offices in more than 31 countries, acquired substantially all of the life reinsurance business, operations and staff of Transamerica Reinsurance, the life reinsurance division of the AEGON companies. The business of Transamerica Reinsurance will now be conducted through the SCOR Global Life companies, and Transamerica Reinsurance is no longer affiliated with the AEGON companies.

While articles, treaties and some historic materials may continue to bear the name Transamerica, AEGON is no longer producing new reinsurance business.

Archive Materials

Back to the Future: Low Interest Rates
Reprinted from the March 2011 Messenger newsletter

By George Hrischenko, Marketing Actuary Leader

A period of prolonged low interest rates has beset life insurers for several years now, forcing writers of long term guarantees to face some tough decisions on their management of assets and liabilities, products and pricing. While rates will probably climb again at some point, no one can say when or how quickly this will occur.

Companies must prepare for both upward and downward shifts in interest rates. However, at the moment most companies are more worried about sustained low interest rates.

Low rate concerns are hardly unprecedented; for example, life insurers were particularly concerned about a steep drop in yields in the early 1990s, as the savings and loan crisis unfolded in the wake of sharply declining residential and commercial real estate values. Capital grew scarce, and hedging grew expensive. Then as now, insurers assessed risks, widened the range of their extreme event scenarios, made adjustments to products and waited out the storm until favorable conditions and strong sales returned.

The Situation Now

For the past three years, life insurers have operated in an environment with very low interest rates and bond yields, thinner margins and greater volatility than was the case two decades ago. While a slow recovery in rates is the most likely scenario according to Moody’s, carriers continue to be concerned about sustained low rates. This situation has already affected life insurers in a number of ways:

New premiums invested in low yielding assets. As older bonds mature and insurers go looking for new paper, low rates would pose significant reinvestment risk. According to the July 2010 Moody’s Statistical Handbook: Life Insurance, median net investment yield for individual life companies was 5.64 percent. During the month of July 2010, yields on 30-year Treasury bonds ranged between 3.83 and 4.14 percent, a 150-181 basis point difference.
<table>
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<th>3-Mo T-bill</th>
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<td>2.02</td>
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</table>

**Figure 1: Historical U.S. Treasury Yields, 1980-2010.** As low as rates are today, there is room for rates to fall further. In late 2008, 30-year bond yields were in the sub three percent range. In fall 2010, 10-year bonds were under three percent.

**Portfolio returns.** Companies support their product guarantees with investment returns on their portfolios of assets held. So long as companies are replacing maturing assets with low-yield “new money” their overall portfolio returns will decline. Stock companies that are heavy in whole life or UL policies with high guaranteed minimums are probably the most exposed to this particular challenge but everyone’s returns are affected.

**Guaranteed level term products.** Low rates have put the brakes on term carrier price competition, which has had an impact on lapse rates. When yields were higher, companies could afford to lower premiums to stimulate replacement of coverage; ultimate level period lapse assumptions were in the six to seven percent range. Now, with yields as low as they are, term rates are fairly stable and level period ultimate lapse rate assumptions are closer to two or three percent.

**Bond investment values.** There is some good news. With current yields down, bonds held as assets have risen in value, strengthening companies’ balance sheets.

The amount of statutory reserves that must be held by direct writers depends on the statutory discount rate. In principle, falling interest rates should drive down the statutory discount rate, thereby increasing reserve expenses for insurers. In practice, the statutory discount rate has been pegged at four percent since 2006, despite significant declines in market yields, so it unlikely that statutory discount rates will increase quickly if and when interest rates pick up.

**What Companies Can Do**
Some options available to companies include:

• **Re-price products.** Carriers can always raise premiums on new business to cover changes in expected mortality, operating expenses and interest rates. However, no one wants to be the first to move into the spotlight and raise premiums to cover not only lower rates but higher uncertainty around future trends.

• **Adjust guarantees and minimum credited rates.** While companies have to honor guarantees like minimum crediting rates on inforce and level-term premiums, they can adjust dividends and credited rates on UL designs and pass on some of the impact of reduced investment returns to the consumer.

• **Redesign products.** To make more efficient use of capital, many insurers are modifying products to reduce the duration of liabilities, the costs of guarantees and exposure to tail risk scenarios. Term-in-a-UL-chassis is one such development.

• **Suspend sales/discontinue products.** When modifications to pricing and product features aren’t enough, the choices are limited to either running with the same risk/return profile or exiting the market. Some carriers are suspending sales in product lines – sometimes permanently. Examples include long-term care insurance and retirement-income products with minimum-income levels. Certain carriers are even dropping new term and UL sales.

• **Seek better asset risk/return mix.** But where? All markets are volatile, and regulatory guidelines and credit rating
agency pressure compel companies to invest mostly in high-quality fixed-income assets. Most corporate paper is too short in duration to be useful to carriers, and hedging in general is much more expensive than it was before the crash. Some insurers might be able to acquire higher yield commercial paper at acceptable risk levels but for most companies’ investment guidelines, it’s Treasury bonds or nothing.

Lower ROI targets. In 2011, Towers Watson conducted its Pricing Methodology Survey of 82 individual life companies, 17 of them mutual or fraternal organizations. According to survey results: In 2009, the median ROI target for stock life carriers was 12 percent; the median actual return was 9.6 percent. In contrast, the median ROI target for mutual life carriers was 9.0 percent; the median actual return was 8.9 percent. Stock companies may have to accept ROI targets closer to those of their mutual counterparts.

**Reinsurance Can Help**

No one knows how long low yields will continue, but even if rates start to pick up soon, the positive benefits won’t show up for a while. Portfolio returns would only recover slowly. Statutory discount rates would rise slowly as well. Regardless of what happens – rates stay flat, go up or go down – the impact of low interest rates will be with us for a while.

A reinsurance partner can help carriers mitigate the impact of reduced expected profitability caused by low rates on their new and inforce business. One way we can help is to analyze your post-level-term pricing to mitigate lapse and possibly improve your inforce block performance. As an expert in both mortality and financial risk, Transamerica Reinsurance is well positioned to help you make the most of the situation.