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Jim McArdle: We've seen a big bounce back in the stock prices of insurance companies since the depth of the financial crisis. In your view, do you think the health of the industry today is better or worse than you might have thought a couple years ago, and why?

Colin Devine: I'm not sure I understood why the big names got crushed the way they did. You would have thought everybody was going out of business. Banks can have runs, but life insurance companies? I don’t think anybody had liquid liabilities. So I thought the industry was in a lot better shape than the banks. But not the way the stocks have been performing. I agree there's been a bounce back – some of these stocks are up four or five times from the bottom. You know their liabilities. I mean, you've got a much more informed view than I do. A couple years ago, I'm going, “Look, they're not that bad.” Now I'm just worried they're not that good. That's kind of how I look at it: It wasn't that bad but it's not that good.

My concern – and this applies to some companies more than others – is the risk taken on the liability side of the balance sheets. I don’t worry that much about the asset side. But as we look at products such as variable annuities with living benefits, secondary guarantee UL, long term care, and even multi-year level term – companies may not go out of business but the industry is going to struggle to get ROEs back up to 12-13 percent.

JM: Has something changed recently on the liability side or is it the accumulation of that risk over time that has raised these concerns?

CD: The thesis that this is an issue has been developing but validation came last fall. Actually, I get validation in a couple of ways: First, if I don’t see a lot of reinsurance being done on secondary guarantee UL and variable annuities, that’s a clue. Then, in the third quarter of last year, the Canadian companies recognized charges for what they refer to as “adverse policyholder behavior,” though there’s nothing adverse about it – the policyholders are being perfectly rational. I think this foreshadows what may be coming south of the border.

JM: When you have an opportunity to talk to life company management about these issues, what are you hearing?

CD: I often get the feeling that CEOs and executive management need a better...
understanding of how their products are used in the field. The people selling the products have one motivation – sales. Management and shareholders live with the consequences. In too many companies the actuaries tend to report to sales rather than to the CEO, so they don’t have as much influence with the CEO as they should. The CEO talks with the chief investment officer multiple times a day – back and forth, back and forth – but far less often with the chief actuary, even though you can lose a lot more money a lot faster on the liability side of the balance sheet than you can on the asset side.

The silos amaze me. Actuarial is on their floor, sales is on their floor, and they don’t talk too much. If I were a chief actuary, I’d want my folks out with the sales people. I’d want them at the sales conferences. I’d want them to hear how products are sold and who they’re sold to – which may be very different from what they thought.

**JM:** Do you think the customer’s motivation for purchase and use of these products has changed significantly?

**CD:** Think of universal life. It went from a middle class to a wealthier class product, and then it started going into ILITs (irrevocable life insurance trusts) for estate planning purposes. Totally different client, totally different policy size. And what’s the lapse rate on ILITs? Zero, right? When they die. Think of variable annuities (VAs). They were designed to be tax-deferred savings products. The data I see suggests that a third of the people – more when you get past the IRS penalties – use them effectively as immediate annuities. If I put these liabilities on my balance sheet as immediate annuities that’s a very different financial position.

**Investor Metrics**

**JM:** As a stock analyst, what’s at the top of your list when it comes to assessing the attractiveness of a company?

**CD:** Today it’s all about the liabilities. I want companies that I think have predictable liabilities. That could be group life, group disability, short duration business. I can get comfortable looking at the asset side – who took sensible risks, who didn’t. I think the rating agencies and regulators get that part, too. But the liabilities, unfortunately, are within that actuarial black box. That’s the mistake I’m going to have to live with. That’s what can trigger reserve adds and hold down ROE.

**JM:** Where do earnings and sales growth fit in right now as a measure for recommending a particular stock?

**CD:** If I see growth, especially in VAs, I get worried. If a company tells me their VA sales are up 45, 50, 100 percent, unless it’s off a small base or they’ve been out of the market for a year or two, I get worried. Then all I have to do is call up my wholesalers who tell me exactly what’s driving the sales, and if it’s a market share grab. Same with group life. Growth in the group life market is basically zero because of unemployment. I don’t think there’s a special sauce for underwriting group life. Investors want to know that there aren’t any time bombs sitting there that will require big reserves.

I focus on balance sheets and assets. I want to see some earnings. But the best life stocks are generally the most boring, right? When investors want excitement there are lots of other sectors to buy. Life insurance companies shouldn’t be a source of volatility in a portfolio.

The challenge today is that if you’ve got a problem the only way to fix it, frankly, is one policy at a time. You’ve got to de-risk the products and focus on profitability – quality not volume. Your sales are probably going to slow, right? Which is not popular with Wall Street because the street loves sales. Some companies are doing this, and I think it’s the right thing. They’re shrinking their books before they can grow again. Ultimately, what drives stock prices over the long term is the ability to grow book value. Because that’s where you see who is doing quality underwriting and quality investing and who knows what they’re selling.

**JM:** What do the major shareholders want life company management to focus on? What are their expectations?

**CD:** The way you win on Wall Street
is you under-commit and over-deliver. The slow steady approach works. That's been the strategy of some of the stocks that have outperformed on a relative basis over the past year. Don’t set the bar too high, don’t be too aggressive. It’s the old, “Sometimes the tortoise wins the race”, right?
Again, when you’re building a block of liabilities, especially long tail ones that you can’t reprice, you need to understand how your product is designed and how it compares with others. Then you watch it closely so you know how it’s being sold, who it’s being sold to and for what purpose.

**Product Risks and Opportunities**

**JM:** Do you think the industry has been helped by the increased role of risk management and the resources being directed into this area — everything from oversight committees to hedging strategies?

**CD:** It’s all helped. But again, I look at the reporting lines and where the chief actuary fits in. When I see that the chief actuary doesn’t report directly to the CEO, I start to question whether the person at the top is getting the whole story. With Sarbanes-Oxley the CEO and the CFO need to sign off on the certified statements. In Canada, the chief actuary does, too.

Hedging helps a lot but it’s not going to solve everything. It’s all based on assumptions. And you need to get into the field and really sift through the data to validate your assumptions. You tell me, would you charge everyone the same price for life insurance? Obviously not. So why do we charge everyone the same price for variable annuities? As far as I can tell, annuity buyers behave very differently.

**JM:** Staying on products, what’s your view of some of the new product features being marketed today?

**CD:** I think life and annuity products still have too many gimmicks, and the features are priced too aggressively. Long term care is interesting. Obviously there’s a huge demand but I haven’t seen one company make any money at it, which tells me that the LTC risk, in its traditional form, is uninsurable.

I like products that allow acceleration of death benefits to cover a long term care need. To me, that’s the kind of innovation we need because it gets the industry back to underwriting mortality, which is what it does best. It also gives life insurance multiple uses and makes it much more saleable. Legislation is probably going to change to help encourage this as well, because clearly the need is great and something’s got to be done.

You know, living benefit VAs serve a real need, too. This industry, by and large, just needs more discipline in pricing them.

**JM:** Longevity is another area of high interest. It’s gotten attention for some time, but lately it seems to be getting more traction.

**CD:** There is tremendous opportunity but you’ve got to have the capital to service the need. I think some of the big, diversified companies are going to do well. People need insurance products to manage the risk that used to be managed by a pension plan. Very few of us can do it on our own. I don’t think I can, and that’s why I have nine annuities. I’m not going to fund them all. I'll load up the ones I think are going to be winners. I want the insurance professionals in there.

Having said that, I think some of the big, well-branded mutual fund companies will go it alone. They don’t want the risk — they’ve seen what can happen there — so they’ll look for reinsurers. But they’re doing their homework. I look at some of the behavioral marketing research being done by the big fund companies. They’re studying when and why people annuitize and what goes into the decisions. Once you understand the behavioral piece you can price the lapse assumption, which you’ve got to get right.

**Rating Agencies and Regulation**

**JM:** What is your view of the role of the rating agencies in the insurance industry?

**CD:** You know I used to work for Standard & Poor’s, so I’ve got a pretty strong view on that. The ratings agencies are another regulator. Clearly, they’ve had a pretty tough patch – though not their insurance group, for the most part. When
you look at the number of failures versus the banks, it’s hard to say they’re not doing their job. Policyholders aren’t suffering through insolvencies. Having said that, I think the rating agencies could have done a better job at getting to the risks in some of the newer products. There are many insurers around today who wrote products they will have to live with for 20 years and pay the consequences. The rating agencies have a very important role to play. I like having three big ones because they balance each other off, do the “good cop/bad cop,” and we get to where we need to be.

**JM:** What about the state regulators and how they have worked with the insurance industry over the last couple of years?

**CD:** I love the guys up in New York State. They’re pretty tough, and they like that. If I judge by the number of insolvencies, it’s hard to make the case for federal regulation. It hasn’t worked too well for the banks. In Canada they have one central regulator yet companies were still allowed to run up large unhedged equity risk positions.

I think regulators have done a good job. As do the rating agencies. It’s about protecting the policyholders and not knee-jerking around like the stock markets. Whenever a stock I covered was down 80 percent, and it looked like they were all going bust, the regulators looked through that. They didn’t panic over unrealized asset losses on bond portfolios. Life insurers have un-liquid liabilities. They don’t have runs on the bank. Both the regulators and the rating agencies took the proper view. I think they accounted for themselves extremely well. But it’s not finished. And with things like VACARVM, companies are doing everything they can to minimize the financial implications. The regulators tried to make the rules tougher but we’re not there yet!

**JM:** On that topic, then, what are your thoughts on Solvency II?

**CD:** I personally think Canadian GAAP is the best, not just because I’m from Canada. It balances the volatility you can get with the new Solvency II and the IAIS standards versus US GAAP, which I think just lets you kid yourself for a period of time by understating the real economic impairments. That said, if I had to choose among them all, I say bring on the new standards. There will be a lot less gamesmanship and more focus on cash flows. Marking liabilities to market is going to be very subjective, but I think we need to go there. Ever since 1992-1993, the risks in this industry have steadily shifted to the liability side but the accounting has not kept pace with that. So, while it may change the way products are priced and hedged, we’ll start acting more sensibly. These new rules will better reflect a company’s true economics. For an investor, that’s what it’s all about.