



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

The Forecaster

The Financial Crisis and Life Insurance



By Glenn Cunningham,
Executive Vice President,
Life Reinsurance

The downturn affecting the financial markets is having a significant impact on the life insurance industry. Glenn Cunningham, Executive Vice President of Life Reinsurance, discussed the ramifications with Robert Klein, Associate Professor of Risk Management and Insurance and Director of the Center for Risk Management and Insurance Research at Georgia State University. Dr. Klein believes that unprecedented events have exposed regulatory and reporting weaknesses. However, he stresses that prudent regulation should not interfere with how companies respond to customer needs, and that greater transparency should be the goal of any reform.

Dr. Klein's focus at Georgia State centers on the insurance market, regulation and other public policy issues. Before joining the faculty at Georgia State, he held a number of positions with insurance regulatory bodies. Most recently he was Director of Research and Chief Economist for the National Association of Insurance Commissioners. He received his BA, MA and PhD in economics from Michigan State University.



By Robert Klein, PhD,
Associate Professor and
Director,
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Glenn Cunningham: For the past 20 years we have seen an increasingly free market approach to the financial markets. Given recent events, do you expect this to change in 2009?

Robert Klein: I think we may see activity on two fronts – at the financial institution level and at the market level. It's fairly certain that we will see some changes in how financial firms are regulated. This will include consolidating regulatory oversight into fewer agencies.

I think there's less consensus on whether certain financial markets should be subject to greater regulatory oversight, but it is a subject that will generate considerable discussion at the very least. It's possible that the new Administration may push for controls on mortgage-backed securities (MBS's) and credit default swaps. Increasing market transparency would be a less intrusive approach.

Any institution that ultimately receives federal financial assistance will likely be subject to commensurate federal regulation. In my mind, proper public policy suggests that some level of appropriate oversight needs to accompany any federal backstopping. Extending regulation to financial markets is a more challenging proposition because there are questions as to whether such regulation is warranted and how it would affect market innovation and efficiency. Concerns about systemic risk are understandable but one has to draw a line somewhere between institutions that should be regulated – and this presumably includes banks and insurers – and firms or market participants for which regulation is not feasible. If the principal financial institutions exercise adequate discipline it will help to impose greater discipline in markets that are not subject to direct regulation.

I do expect to see stronger and hopefully more comprehensive institutional regulation but it may not be resolved in one year. Divisions still need to be addressed regarding the application of regulatory authority as well as type and level of oversight.

GC: How has current regulation fared, and could we now see an overreaction?

RK: I seriously question whether stricter regulatory oversight would have prevented the

current crisis. At the time these instruments (e.g., MBS's) and the markets in which they trade were evolving (and Gramm-Leach-Bliley was being enacted), no one could have contemplated the scenario that has occurred and put in place a regulatory framework to prevent it. And even if such views had developed the political will wouldn't have been there to follow through on them.

We will have new regulation but I think there's a sense of realism with respect to what we can achieve with it. Again, the question now is whether you correct past mistakes through regulation of institutions or regulation of markets. I think the most progressive thinkers on this believe all financial institutions should be subject to some form of coordinated oversight within a single agency. I am hesitant to say we need substantial controls on the markets themselves. Maybe at the end of a long debate and analysis someone might present a cogent argument that's persuasive but I'm not prepared to accept it yet.

The thing that policymakers need to keep in mind is that these markets to a large degree serve a legitimate purpose – they wouldn't have evolved otherwise. Misuse or overconfidence has affected them but they play an important role. We need to be careful that supervision still allows room for markets and companies to continue to innovate.

Insurance Regulation

GC: Some life insurers recently have pursued acquiring thrifts in part to access federal relief. What are your views on this?

RK: I'd prefer that companies not be forced to acquire a thrift to access federal assistance. Now if it makes economic sense for them to buy a thrift, so be it. But if they are using them as a device to access financial assistance that otherwise would not be open to them, then that's a concern.

This really is about insurance regulation. If we deem insurers to be significant players in the financial markets, then that is an argument for federal regulation since the states cannot provide access to financial assistance. I think it's time for at least optional federal regulation for insurance companies; then insurers wouldn't have to

buy a thrift to qualify for federal assistance. More importantly, federal oversight would enhance insurers' efficiency and competitiveness and place them on a level playing field with other financial firms.

GC: What federal action do you foresee beyond the optional federal charter?

RK: I think we will ultimately see a comprehensive approach to financial regulatory reform, with an overarching entity and sub-agencies that monitor and regulate specific financial sectors. This would provide some degree of regulatory specialization while ensuring overall efforts are coordinated at some higher level. But gaining consensus on this will be difficult, and it may be some time before we see a truly coordinated structure to financial regulation.

I expect that regulatory restructuring will initially be focused on banking and insurance will be added at some later point. However, it appears that incorporating life insurance into this model early on is receiving some traction because of its closer ties to the financial markets. Whatever decision is made, there's no doubt that politics – state versus federal, bank and insurance, life and P&C, home office and agent – will play a big role in the ultimate outcome.

Accounting Standards and Risk Management

GC: Some features of fair value accounting, particularly mark to market, have come under fire for their roles in the recent financial turmoil. Should fair value be reviewed in light of today's market dynamics?

RK: There are inherent limitations in any accounting system. Book value has its own set of limitations, as we all know. Generally, I support the notion of mark to market but clearly it can create distortions when you have exceptional market volatility. Regulators need to take a discretionary approach in times like this. They shouldn't force companies to raise more capital to shore up reserves for assets that are undervalued simply because the stock market moves 500 points up or down

everyday.

But that said, I understand that there are other institutions such as rating agencies that have a different viewpoint. I think this is where regulators should step in, use their discretion and ease the application of the rules so that companies are not forced to take actions that are neither economically necessary nor prudent, looking at the long term.

GC: Companies have been seen to have a reasonable grasp of the risks that they assume. How has the current economic environment affected this view?

RK: I think at least some insurers need to see if they really do fully understand the risks they face, and if they fully appreciate the potential outcomes associated with some of these risks. Some firms, for example, invested in assets that were less safe than they thought – that’s an operational risk management problem.

But there’s a limit to how much an insurance company can insulate itself from the various risks and still be efficient and play the role that it needs to play. Some companies still need to embrace the concept of enterprise risk management in its true form, but there’s a limit to how safe a company can make itself without significantly affecting its ability to function profitably and serve consumer needs. So while companies and their stakeholders should review all of this, everyone needs to remember the need for balance.

GC: How will companies reassess the models they have been using in light of the recent financial turmoil?

RK: First, they ought to recognize that even the best constructed models aren’t perfect. They are based on information inputs, identified risks and assumptions. Inherently there will be flaws in all of these things.

Models are informative, but regulators and managers should not rely solely on their output to gauge the risk of the firm and what management should do. Judgment, qualitative assessments and recognition of the limits of the models are all very important. And if that’s been underappreciated in the past, I hope that current events would cause people to gain a greater awareness of that.

GC: How will the current economic

environment affect the future of principles-based regulations?

RK: I think the current environment demonstrates the need for a principles-based approach, and the NAIC is moving forward with this concept for life insurance reserving. That process may be accelerated in order to help address some of the industry’s immediate concerns with respect to how the current formulas affect reserve and capital requirements.

How and when the NAIC moves beyond principles-based reserving to other areas, such as capital standards, is less certain. I think the concepts are appropriate but ultimately you have to implement them. This requires developing sophisticated models that will support capital and reserve decisions. And in light of the current market, standards, requirements, processes, etc. must be carefully reviewed and tested.

As you know, the ACLI has made a number of recommendations to the NAIC that would provide more immediate reserve and capital relief for life insurance companies. The regulators have been fairly closed-mouthed about what they will do. As we discussed, there are just so many vested interests, including regulators, companies, analysts and rating agencies. But based on the few public comments I have seen, it appears that they may be amenable to some more benign measures such as the retroactive application of the new mortality tables. There may be greater resistance to making changes to reserve and capital formulas. Still, the NAIC has not completed its deliberations so anything is possible and we won’t know what it has decided until that process is concluded.

Product Risk and Financing

GC: Life insurers have added features to base policies to be more competitive and meet consumer needs. How have these features increased the risk positions of life insurers?

RK: The biggest area of concern is the effect on the more complex product features, such as UL shadow accounts or guaranteed living benefits in some annuity products. In the best of times insurers have a difficult time managing the risks with these features

because they are so dependent on human behavior. And people aren't always rational, which makes modeling especially difficult. I have a feeling that most of these products are bleeding money right now as consumers effectively exercise the options embedded in these features. This isn't the best time for managers to be forced to liquidate investments to honor cash calls.

For insurers the key in times like these is managing capital, while for banks it's managing cash flow. These guarantees – implicit or explicit – change the underlying behavior of the products to make them behave more like banking products. So now these companies must address not only capital strain, but also cash flow problems resulting from these guarantees.

I think this is where trying to be too clever may actually come back to haunt some life insurers, particularly those with large footprints in the variable markets. But for the most part life insurers don't develop these features just on a whim – there's a need, real or perceived, that they are trying to meet. I don't expect companies to change that approach, but they may revisit the features' terms or pricing. And given the demographics, with people approaching retirement or living longer, these kinds of innovations are valuable and important. A philosophy of innovation should continue to be fostered.

GC: Life insurers have looked to the credit markets for competitive financing for mortality risk and reserve and capital strain. What's the outlook for these deals?

RK: The tightening of capital for these deals is not related to their attractiveness. It's just a symptom of what's happening in the larger credit market. Over time the availability of capital will improve but how quickly and broadly this will occur is difficult to say.

I think the long term outlook is good for the securitization of both life insurance and P&C insurance risk because of the benefits that such deals present. They may not be plain vanilla transactions, but they should look much more predictable and secure than mortgages. They won't be the first credit deals to see a resurgence, and the price structures may change, but I'm confident we'll see demand increase.

GC: Final thoughts?

RK: One of the fundamental economic problems that contributed to current conditions was the tremendous increase in the amount of leverage involved in market transactions. There is a difference between borrowing money to invest in things that will create true economic value and borrowing to engage in highly speculative ventures and excessive consumption. There has been too much of the latter, and when the real estate bubble burst the inevitable fallout occurred with cascading effects on financial markets and the economy. And that's what needs to get resolved and worked out.



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