Lessons from Life Insurers who have got into difficulty

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Agenda

1. Original study in 2001

2. Updated study in 2009

3. Compare lessons learned

Background

- When I was appointed Chief Actuary of Old Mutual
- Wanted to know what I should look out for
- Other life insurers had got into difficulty
- Not intentional
- They must have missed something
- Wanted to find out what they had missed

Study in 2001

- Identified several insurers who had got into difficulty
- Several students / actuaries in Old Mutual investigated what happened to each of these and why
- Presentations to me on what they had learned
- Identified common causes / themes
- Compiled a checklist for myself

Original List

- Several Japanese insurers
- General American (USA)
- Mutual Benefit Life (USA)
- Kentucky Central Life (USA)
- Independent Insurance (UK)
- Equitable Life (UK)
- Lifegro
- Southern Life
- Sage
- Norwich Life
- Fedsure

Original Lessons

- Careful of making decisions based on current investment environment. Allow for conditions to change (lower inflation/interest, market decline).
- Watch out for concentration of liabilities
  - guarantees: match as far as possible
  - liquidity: sufficient allowance, termination clauses
- Charge / reserve sufficiently for guarantees where unmatched.
- Accurate experience records for pricing / reserving.

Original Lessons

- Concentration of assets
  - Strategic holdings
  - Counter party risk
  - Performance risk
- Importance of investment performance.
- Appropriate bonus declarations.
- Appropriateness of reinsurance contracts and credit rating of reinsurer.

Original Lessons

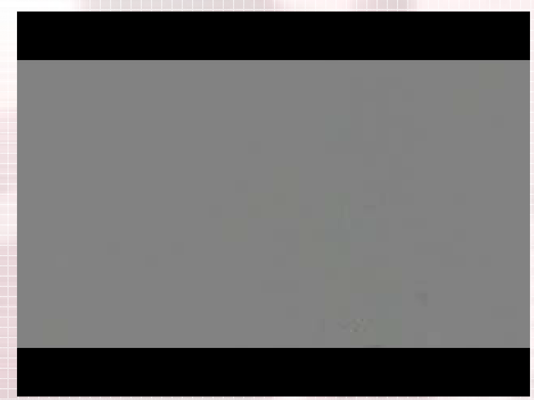
- Assumed management action in adverse circumstances.
  - Policyholder reasonable expectations
- Responding to emerging issues and environment changes sooner rather than later.
- When something looks too good to be true, it usually is!

Updated study 2009

- World financial crisis
  - AIG
  - Hartford
  - Metlife
  - Prudential
  - Aviva
  - Old Mutual US
  - ING Group
  - Lincoln National
  - Yamato Life

World Financial Crisis

- US sub-prime mortgage crisis
- Mortgage backed securities
- Collateralised debt obligations
- Credit default swaps
- Fannie Mae & Freddie Mac
- Bear Sterns
- AIG
- Lehman Brothers
- Merrill Lynch
- Credit spreads
- Equity markets



Acknowledgements

- Series of essays on
- Risk Management: The Current Financial Crisis, Lessons Learned and Future Implications
- Presented by the Society of Actuaries, The Casualty Actuarial Society and the Canadian Institute of Actuaries

- Andrew Linden – research on several life companies who have experienced difficulties recently

Main Causes

ACTUARIAL SOCIETY OF SOUTH AFRICA

- Assumption that house prices would continue to rise
- Separation of incentives for mortgage originators and for those carrying the risk of default
- Separation of decision making and accountability
- Incentives generally too short-term focussed and didn’t reflect risk
- Complex structures (mortgage backed securities, collateralised debt obligations, credit default swaps) used to repackage the risks

Main Causes

- Complex structures not understood
  - Relied on rating agencies
  - Extent of leverage disguised by some structures
  - Inadequate modelling of underlying risks
  - Complex models provided false sense of security
- Difficult to get off or stop the bus
  - Everyone else was doing it
  - Everybody else was making money out of it
  - Interest of participants to keep the momentum going
  - Everyone wants to stay on the bus as long as possible

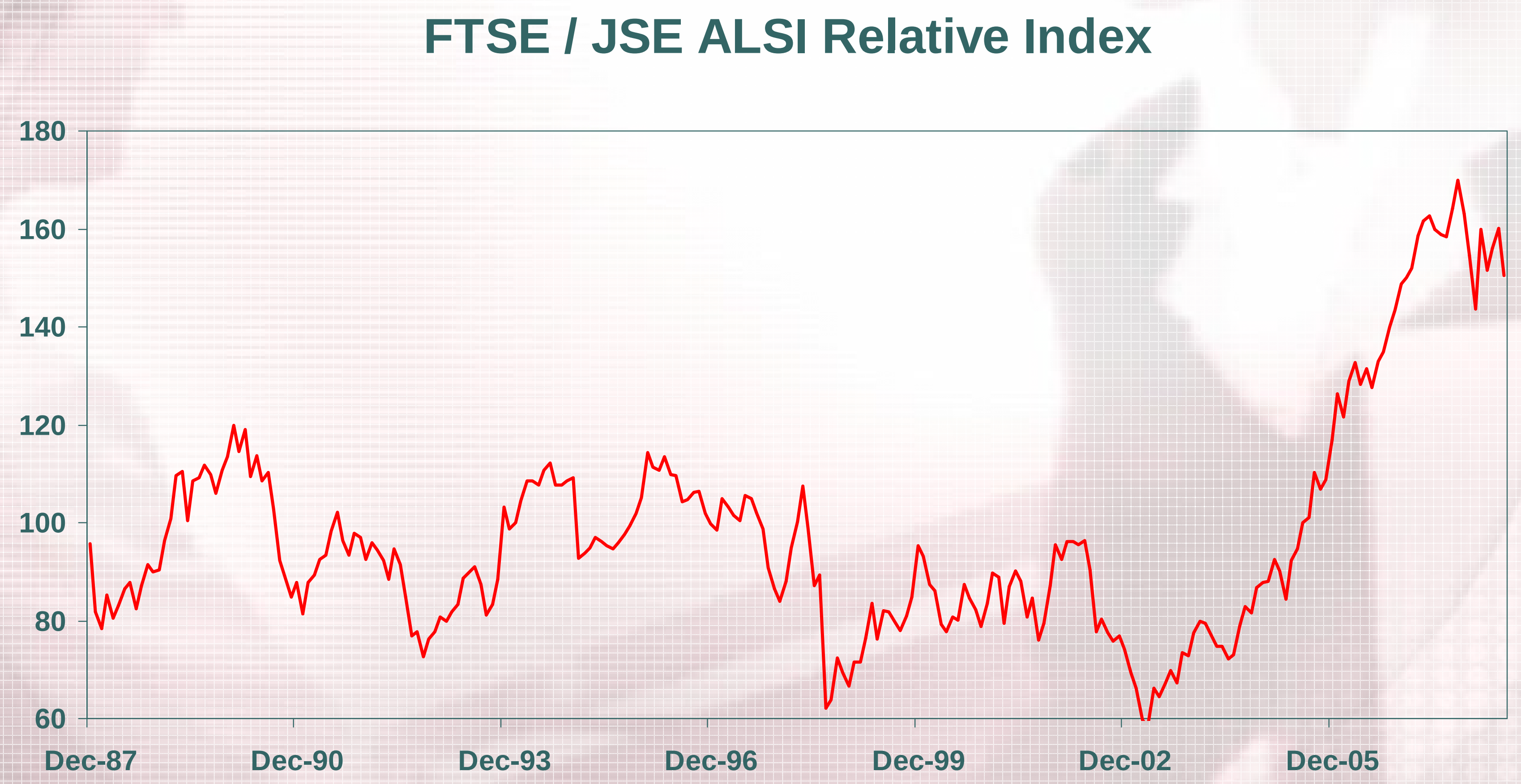
Main Causes

- Bubbles are not too difficult to observe, but it is much harder to predict if and when they will burst.

Bubbles?

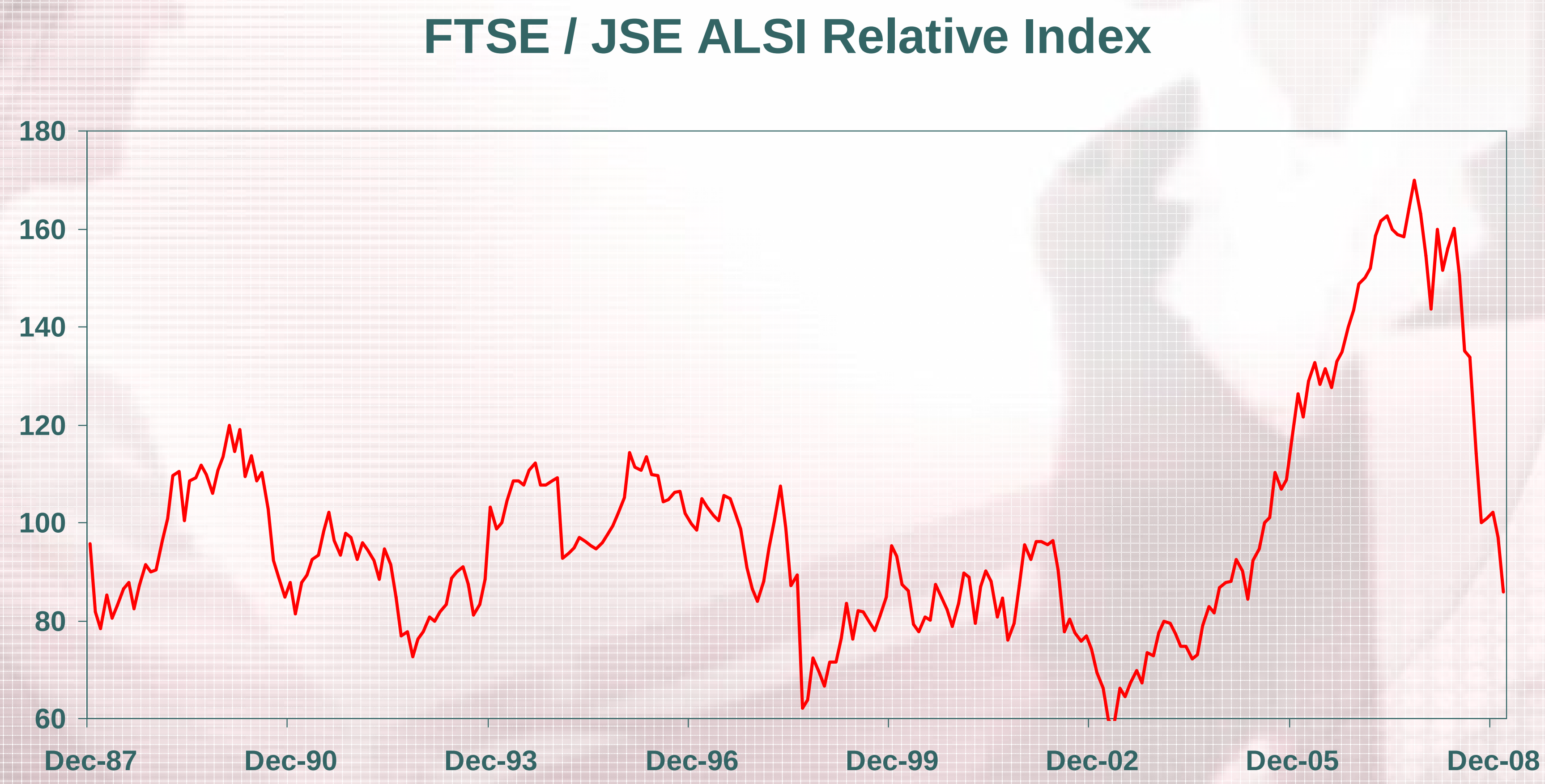
FTSE / JSE ALSI
35,000
30,000
25,000
20,000
15,000
10,000
5,000
0
Dec-87
Dec-90
Dec-93
Dec-96
Dec-99
Dec-02
Dec-05

Bubbles?



FTSE / JSE ALSI Relative Index
180
160
140
120
100
80
60
Dec-87
Dec-90
Dec-93
Dec-96
Dec-99
Dec-02
Dec-05

Bubbles?



FTSE / JSE ALSI Relative Index
180
160
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120
100
80
60
Dec-87
Dec-90
Dec-93
Dec-96
Dec-99
Dec-02
Dec-05
Dec-08

Main Causes

- Bubbles are not too difficult to observe, but it is much harder to predict if and when they will burst.
- Capital regimes based on prevailing market conditions
  - In bull market, risk appetite high, price of risk low, capital required low, hold relatively less capital
  - In bear market, risk appetite low, price of risk high, capital required increases, actual capital has decreased

Main Causes

- Capital regimes converging towards only a one year view of risks
  - Only what capital you need to survive the next 12 months, assuming that you will be able to raise additional capital at the end of the 12 months.
  - But in reality need sufficient capital after a crash to cover higher capital requirements after a crash, because you may not be able to raise capital after a crash.

Lessons Learned

- Don't assume that the past will continue in future
- Take the time to understand complex structures
- Examine risks thoroughly, including the risk of significant changes in the environment
- Recognise that models are not perfect
- Guaranteed termination benefits are dangerous
- Importance of appropriate incentives that allow for risks
- Important to link decision making and accountability

Lessons Learned

- Look again at something that sells too well
- Avoid concentration in one type of product / risk
- Recognise that bubbles will burst one day
- Have the courage get off the bus
- Develop a counter-cyclical regulatory capital model that requires more capital to be held in the good times, and less in the bad times.
- Require higher multiple of CAR when the market is high, and lower multiple when the market is low

Compare Lessons Learned

- Same
  - Still need to allow for / assess unexpected changes in the environment
  - If something sells really well, check it again
- New
  - Don’t be mislead by complex structures and models
  - Appropriate incentives, linking decision making and accountability
  - Recognise bubbles and have the courage to get off the bus
  - Need for counter-cyclical regulatory capital model
  - Question trend towards 12 month capital models

Discussion

- Questions?
- Comments?

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