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The impact of persistently low interest rates

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Interest rates are at historic lows and there is every indication that they will remain there. The US Federal Reserve (the Fed) has publicly stated its commitment to an extremely low interest rate policy; in the December 13, 2011 minutes of its Federal Open Market Committee (FOMC), it reiterated that economic conditions are likely to warrant exceptionally low interest rates through at least mid-2013. Accordingly, companies that assume interest rates will return to "normal" in the near future do so at their own peril.

The low level of interest rates and the period for which they have persisted are unusual but not unprecedented. Following the Great Depression, interest rates were as low as or even lower than they are today and remained so for over ten years. More recently, Japan has experienced a very low interest rate environment for the last two decades.

The Fed is committed to low rates in order to stimulate the economy, most notably to encourage a housing market recovery. Overcapacity in the manufacturing sector, high unemployment and underemployment, and the ability to move manufacturing and services to lower cost locales, are keeping a lid on inflation. And, despite concerns about the long-term health of the US economy, foreign investors still view US treasuries as a safe haven.

For years, industry observers have tried to anticipate the financial impacts of a low interest rate environment on the life insurance industry. Their predictive scenarios have foreseen declining sales, revenue, profitability and company valuations. 2011 saw validation of these forecasts. For instance:

- A large domestic VA writer stopped all new sales;
- A mid-size domestic income annuity writer announced its plans to diversify its product portfolio away from interest sensitive products;
- A large multi-national VA/EIA writer took a large write-off associated with unfavorable policyholder behavior;
- There were numerous company exits or repricings of products with profit streams that are especially vulnerable to low interest rates, namely secondary guarantee universal life and long-term care; and,
- Fixed annuity and universal life credited and policyholder dividend scale interest rates steadily declined.

Implications

- In 2011, life insurers started to feel meaningful effects from the low interest rate environment. If interest rates continue to stay low, then life insurers' financial pain will be broader and deeper. As this environment persists, it is unlikely that any company will be immune to:
  - » Lower investment earnings decreasing revenues;
  - » Smaller margins causing DAC amortization to accelerate;
  - » Traditional products becoming more likely to experience loss recognition; and,
  - » Goodwill potentially becoming impaired as earnings decrease.

- Because companies are reinvesting their cash flows at yields below current portfolio rates, they may be motivated to overreach in their investment decisions to maintain current portfolio yields. Companies may extend duration beyond what is prudent for their liability characteristics or increase credit risk, testing the limits of their risk policies. These will serve to increase regulatory and economic capital requirements, and may prove unattractive on a risk-adjusted basis.
- As we cite above, lower investment income will cause company revenues to decline, and any related decreases in sales will only accelerate the downward trend. In order to maintain margins, companies are likely to aggressively seek ways to reduce expenses. However, expense reduction initiatives have been in place at many companies for some time, and it is uncertain how much more in earnings they can squeeze from this stone. At the same time, increased regulatory and compliance requirements are generating increasing headwinds for any company trying to achieve lower costs.
- The current low interest rate environment is causing companies to re-examine policyholder experience assumptions. Insurers have made experience assumptions, such as those for persistency, renewal premiums, and optional benefit elections, against the historical backdrop of a more "normal" interest rate environment. As the low interest rate environment persists, current policyholder experience is increasingly straying from what insurers have experienced in the past.
- The low interest rate environment is forcing companies to address fundamental strategic issues. The strategic response to a temporary low interest rate environment is understandably different from the response to a prolonged low interest rate environment. If companies assume the current low interest rate environment will be temporary, then a business as usual approach may serve them most effectively. If they expect low interest rates to persist indefinitely, then they should consider fundamentally redesigning their product portfolio to reflect new economic realities.

PwC will release the complete edition of ***Top Issues: The Insurance Industry in 2012*** by mid-March 2012. In addition to the effect of the low interest rate environment on life insurers, the publication will address:

- Strategic risk management
- Solvency
- Dodd-Frank
- Mergers and acquisitions
- Global expansion
- Improving data analysis and use
- Increasing customer power
- Policy administration transformation
- Abandoned property
- FATCA
- SSAP 101

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