



Dealing with the current economic environment

What does the future path look like?

SAS AA Symposium
Keith Walter

3 November 2011

TOWERS WATSON 

Agenda

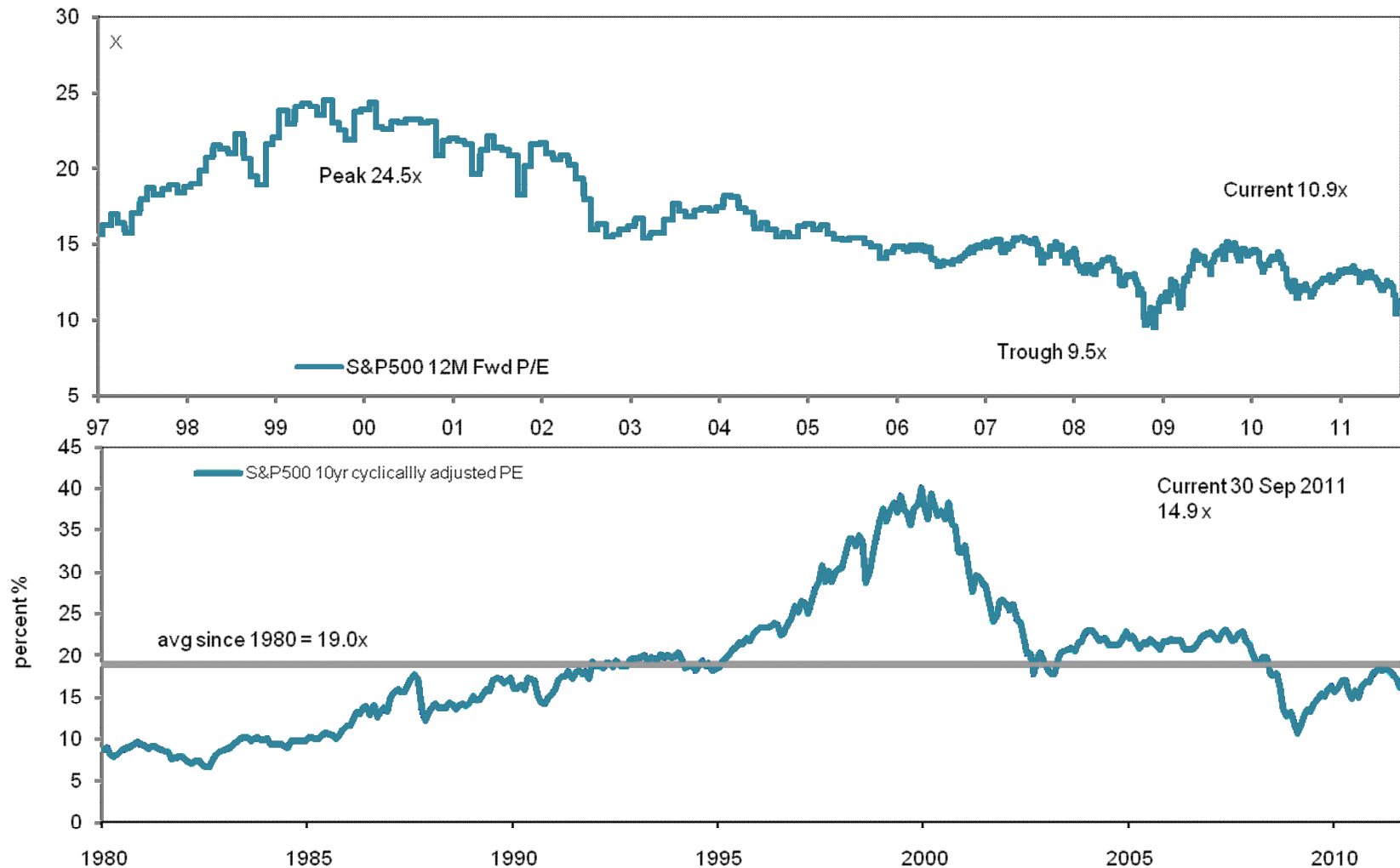
- Review of economic environment
 - Equity Markets
 - Credit Markets
 - Inflation and Exchange Rates
 - Asian Markets
- Discussion of future scenarios
- Implications

Review of Economic Environment

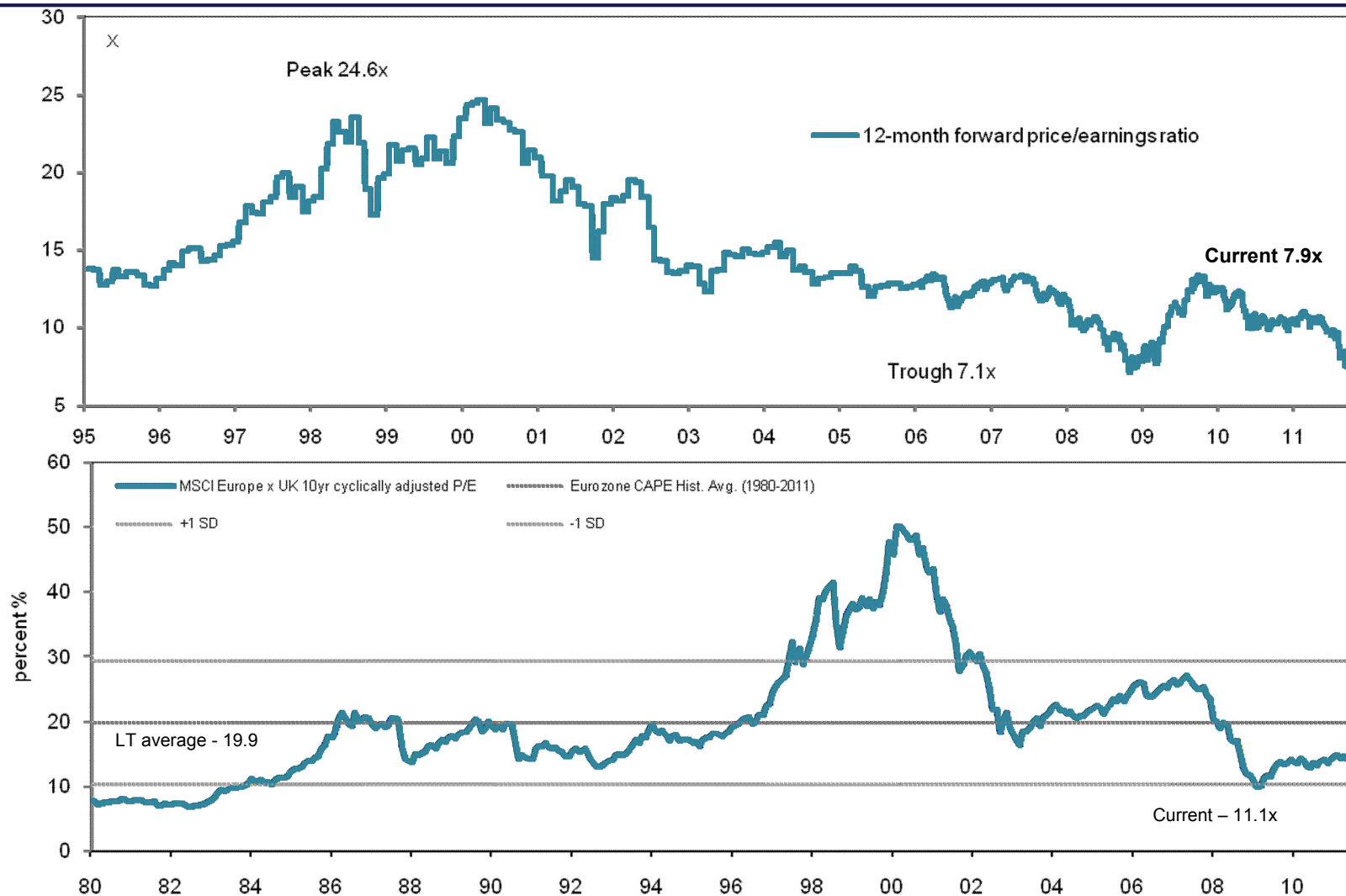
Equity Markets

S&P 500 P/E

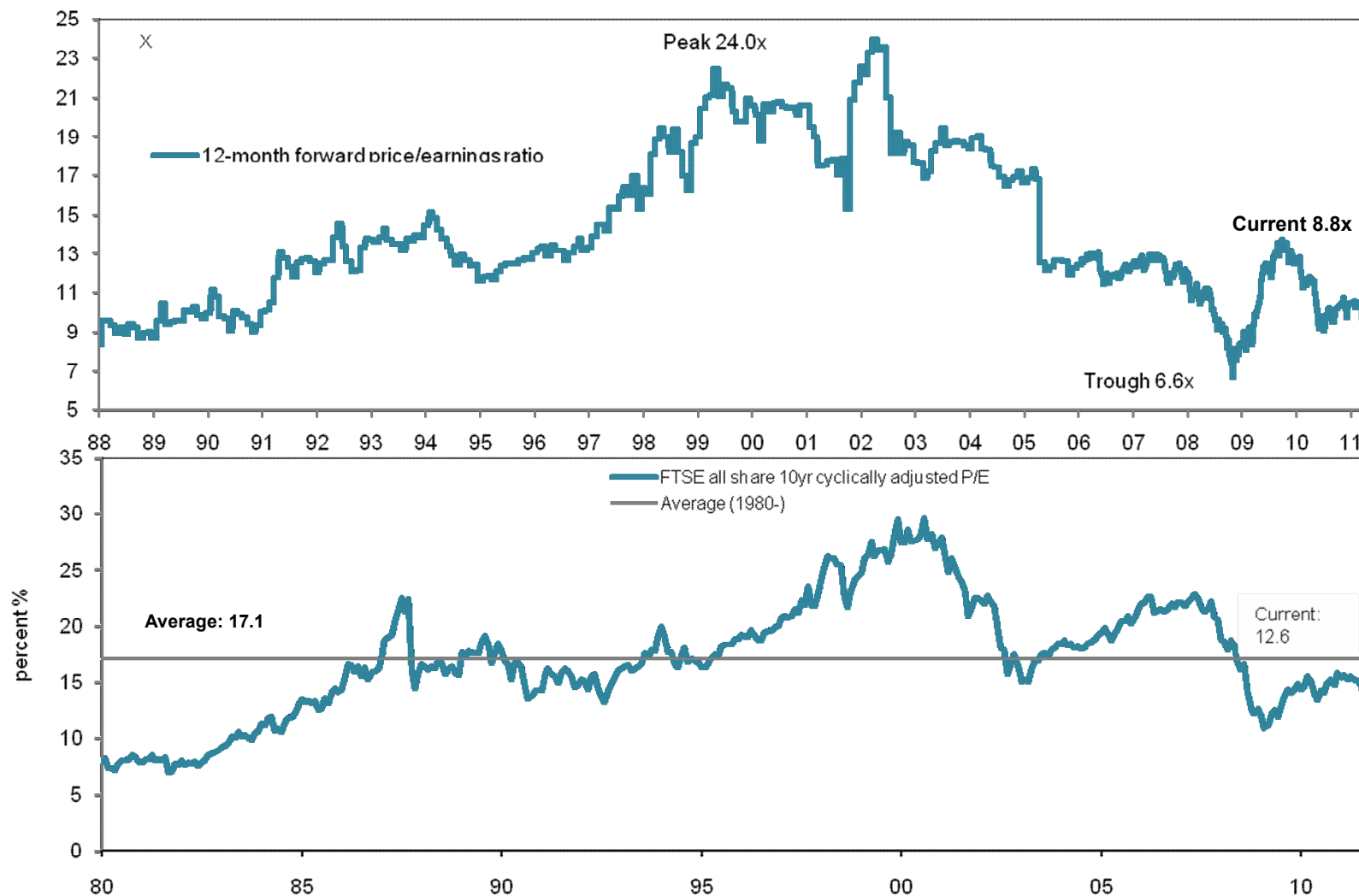
Equities



Euro Area P/E Equities

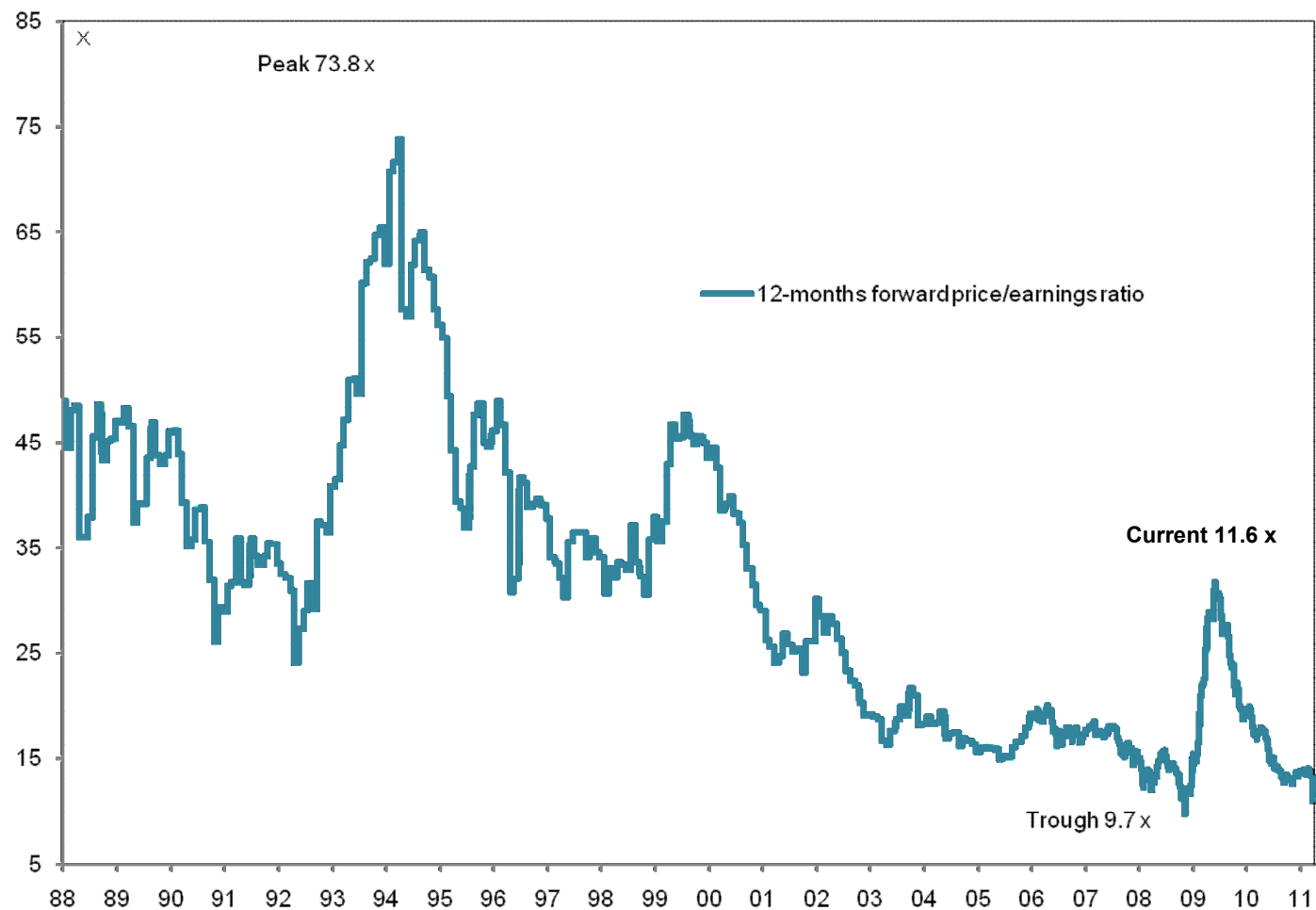


UK PE Equities



Japan P/E

Equities

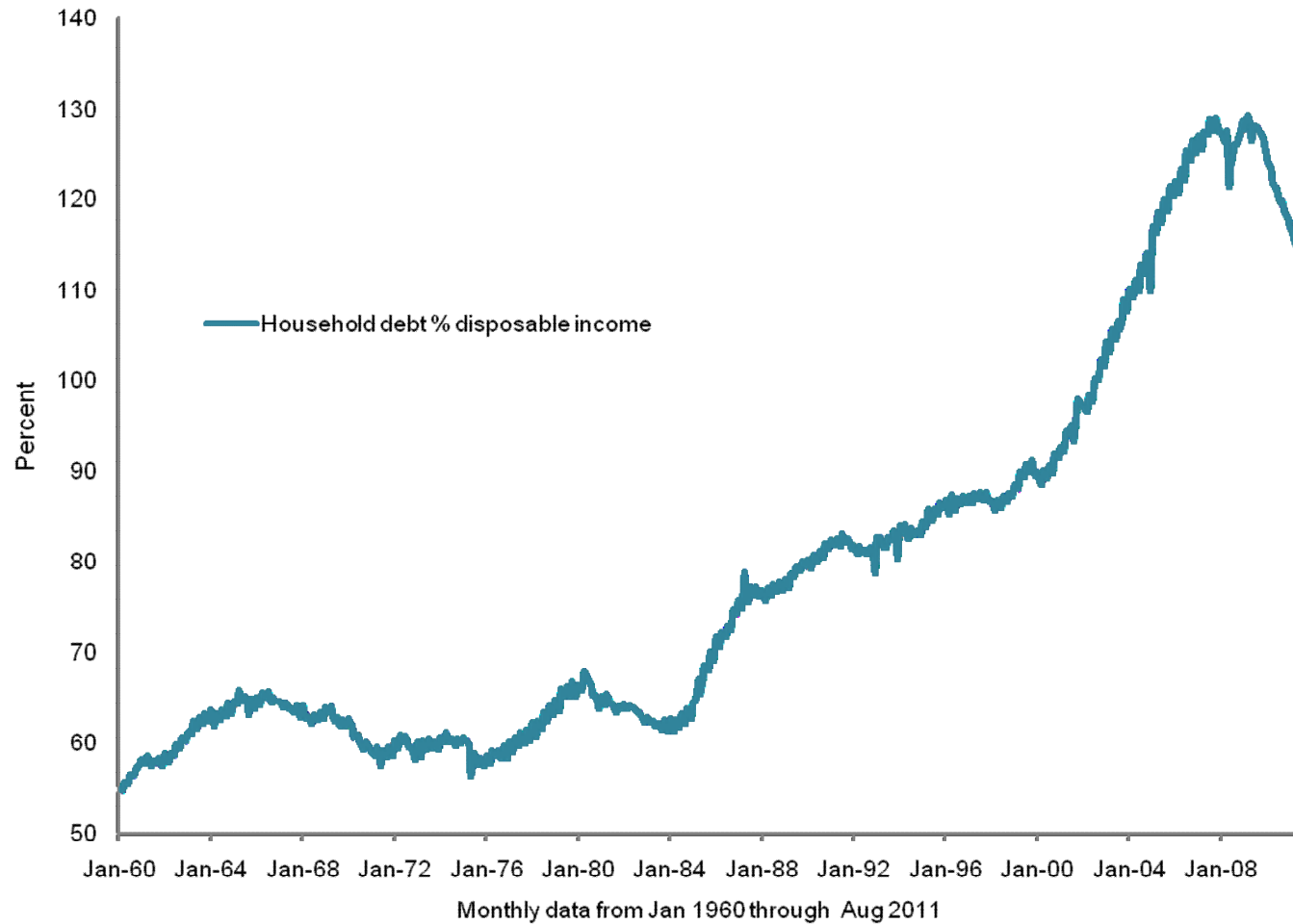


Review of Economic Environment

Credit Markets

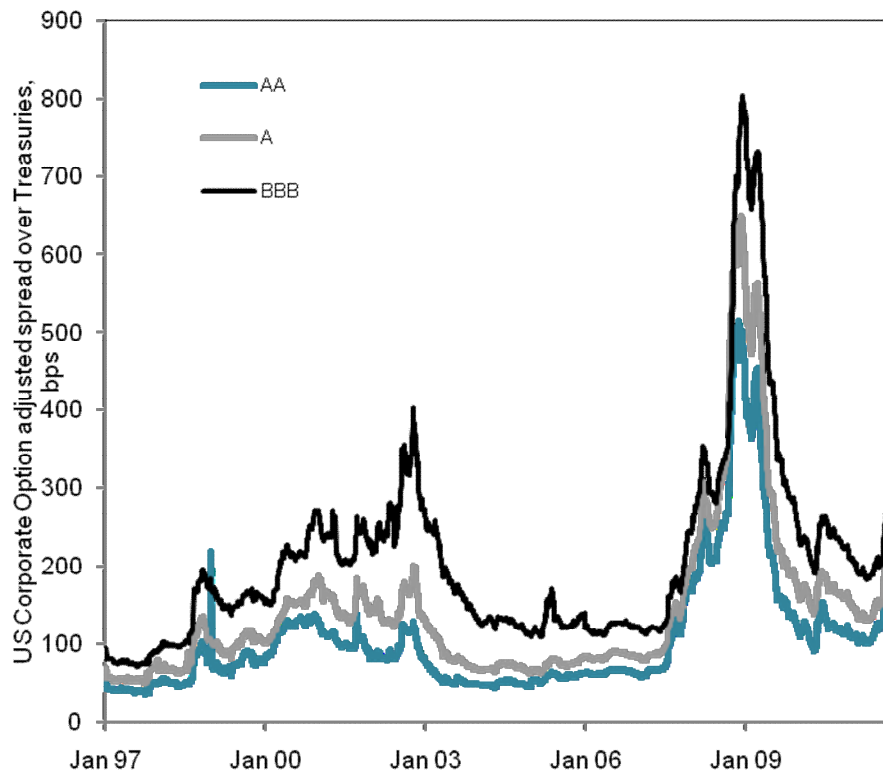
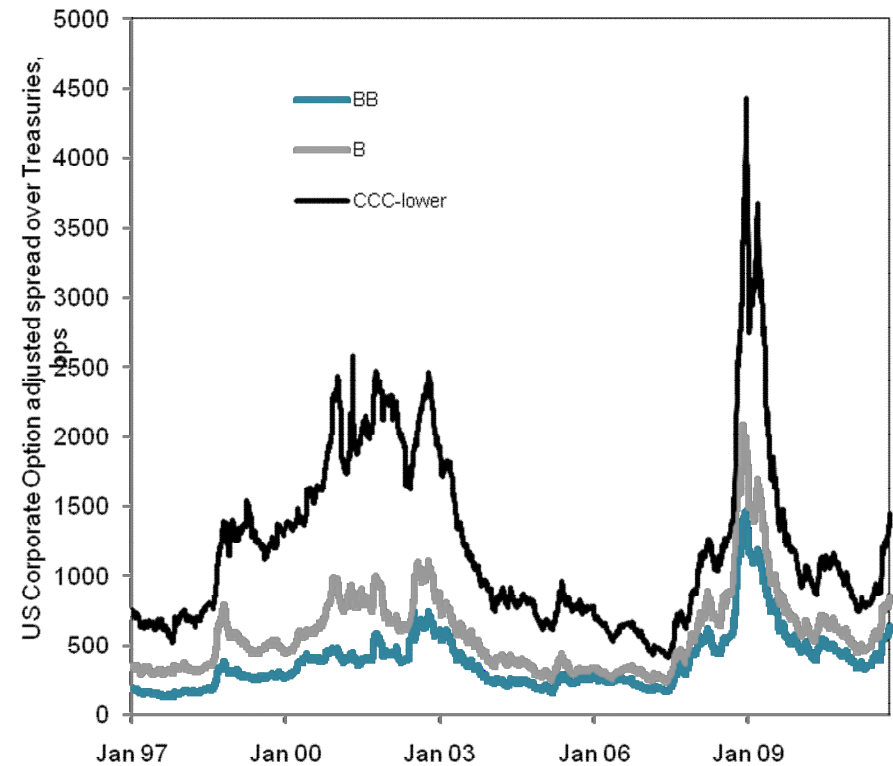
Household debt

US



Corporate spreads

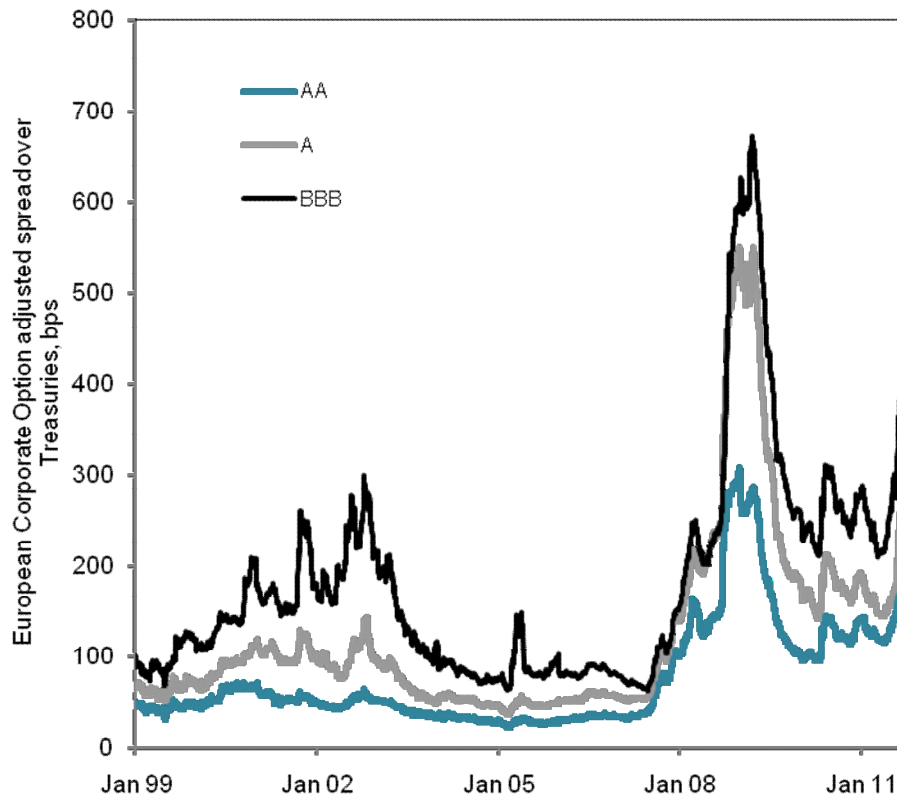
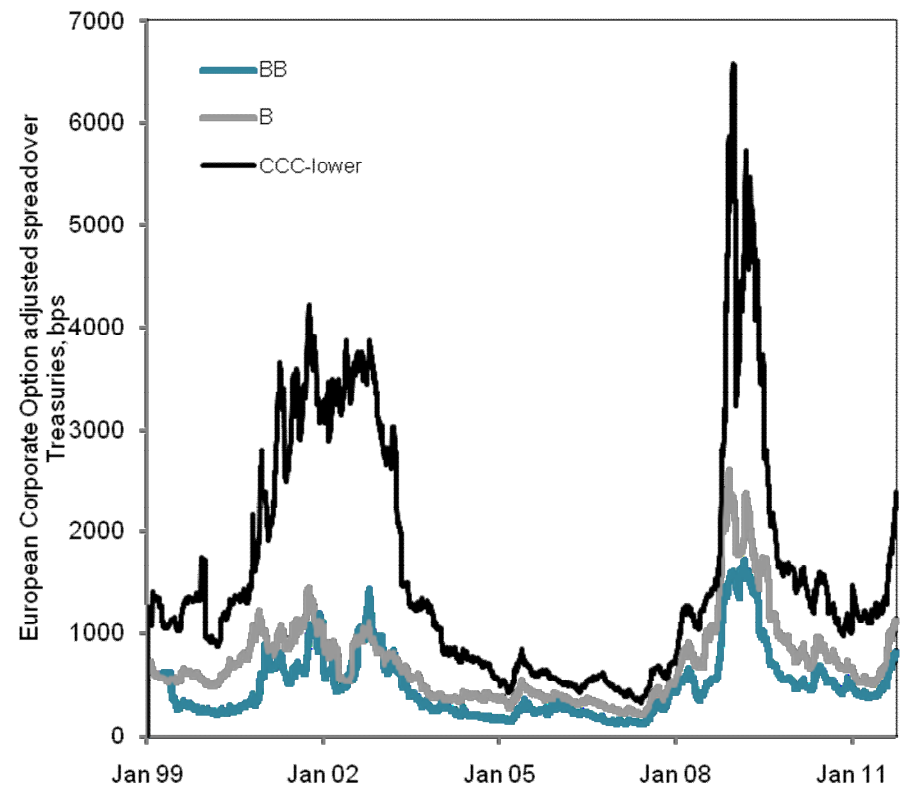
US



Note: Daily data to 30 September 2011

Corporate spreads

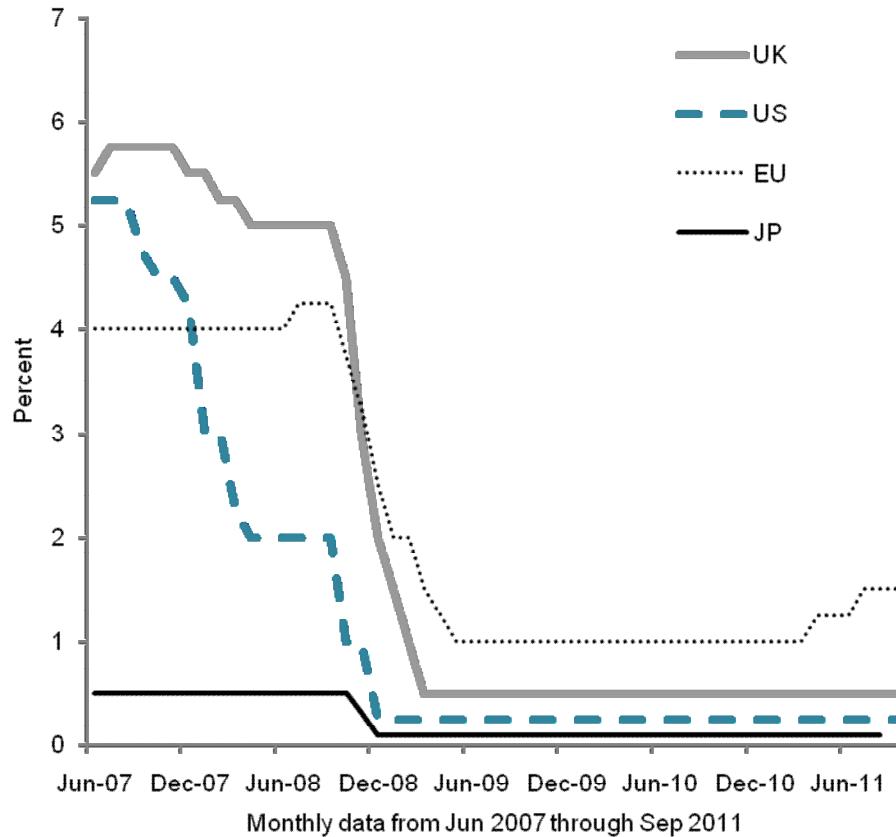
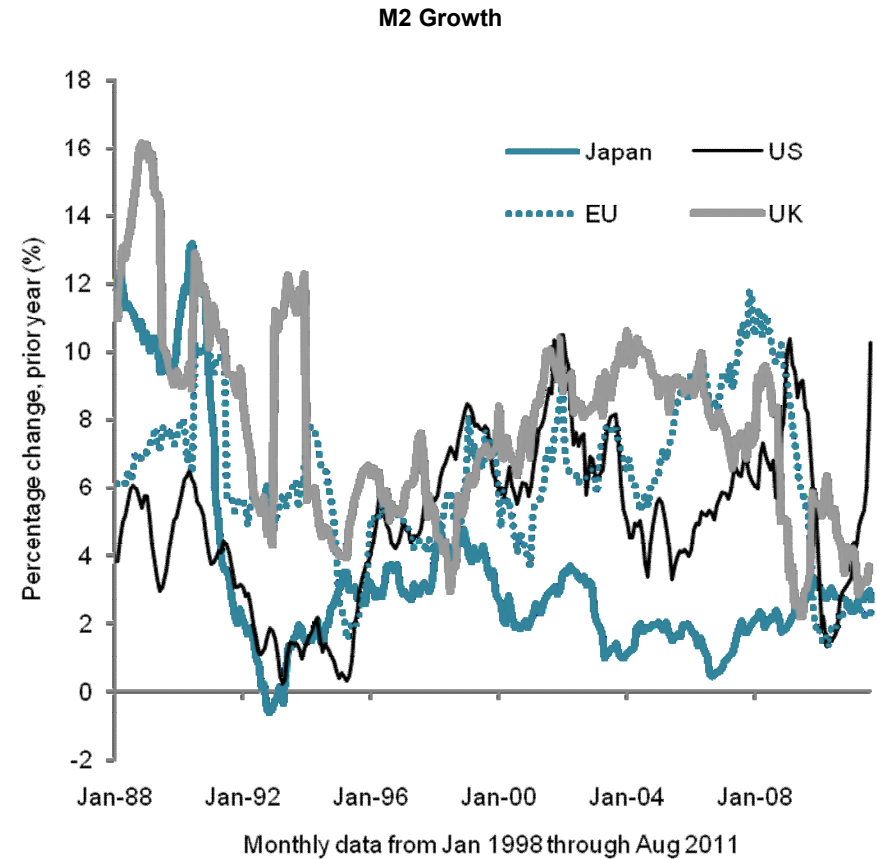
EUR



Note: Daily data to 30 September 2011

Central bank interest rates and money supply

Euroland

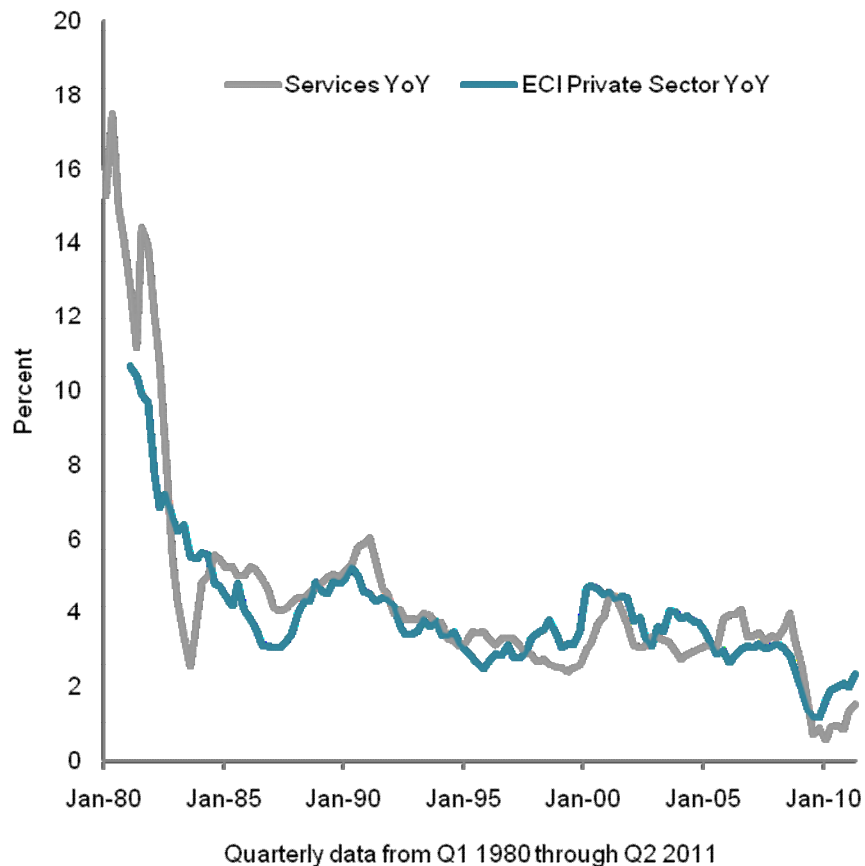
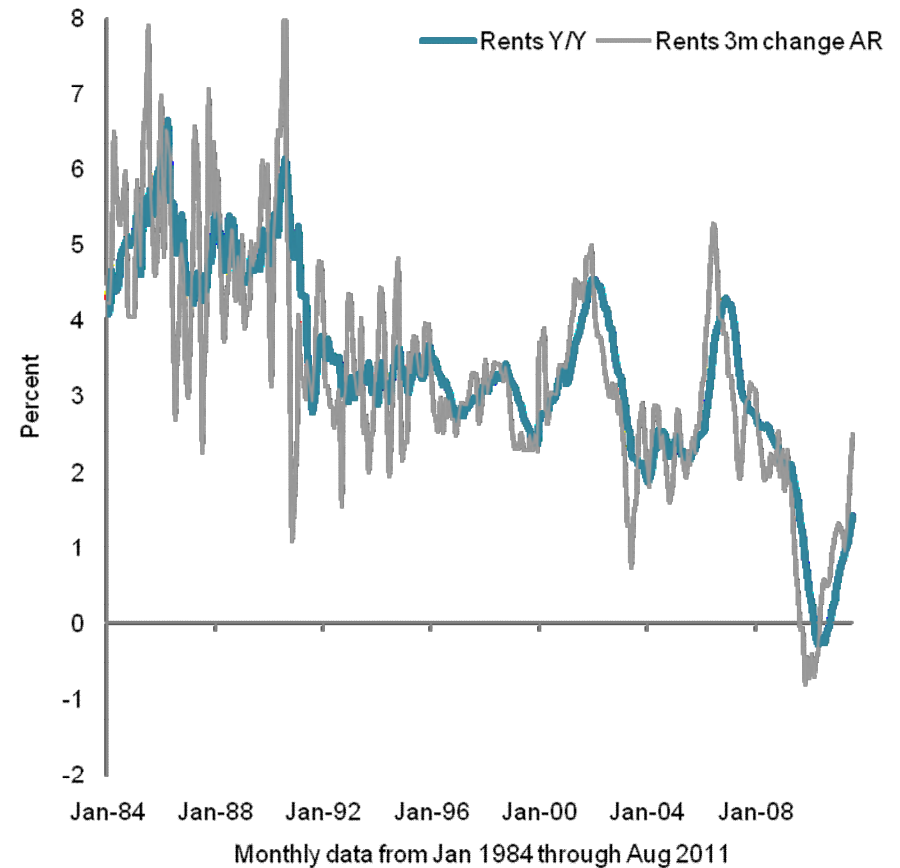


Review of Economic Environment

Inflation and Exchange Rates

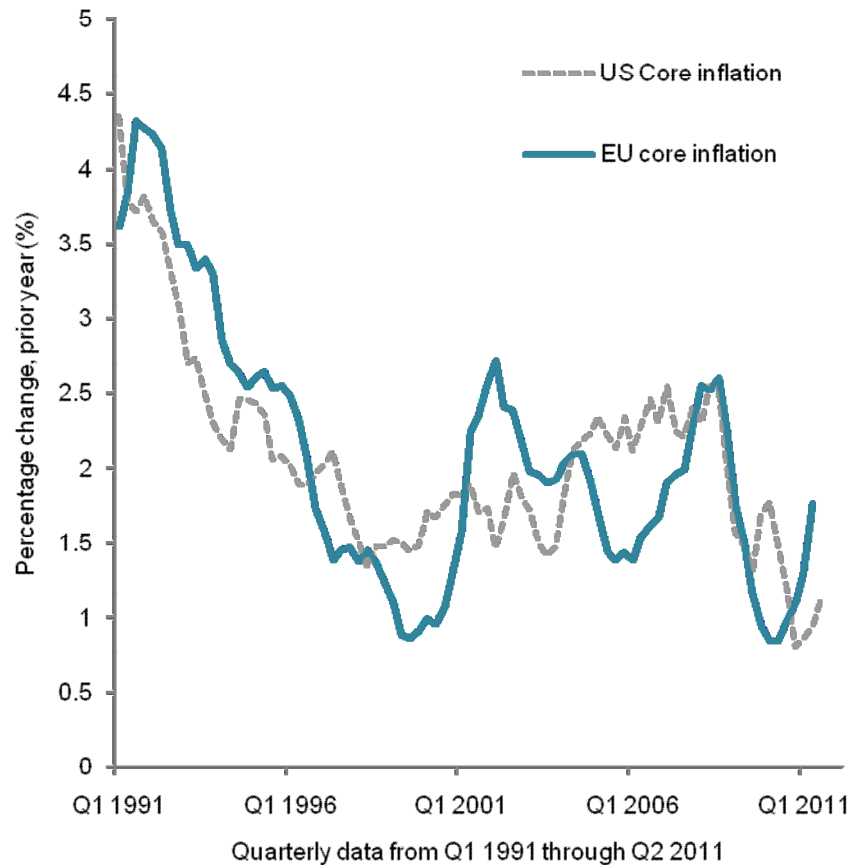
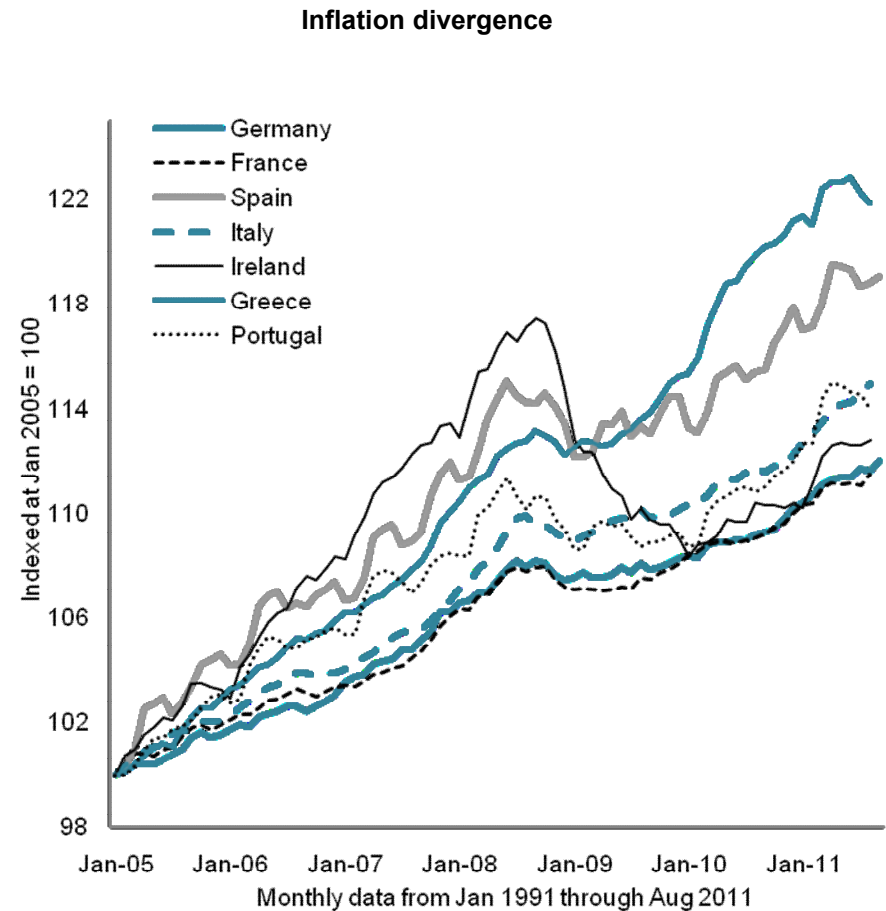
Inflation drivers

US



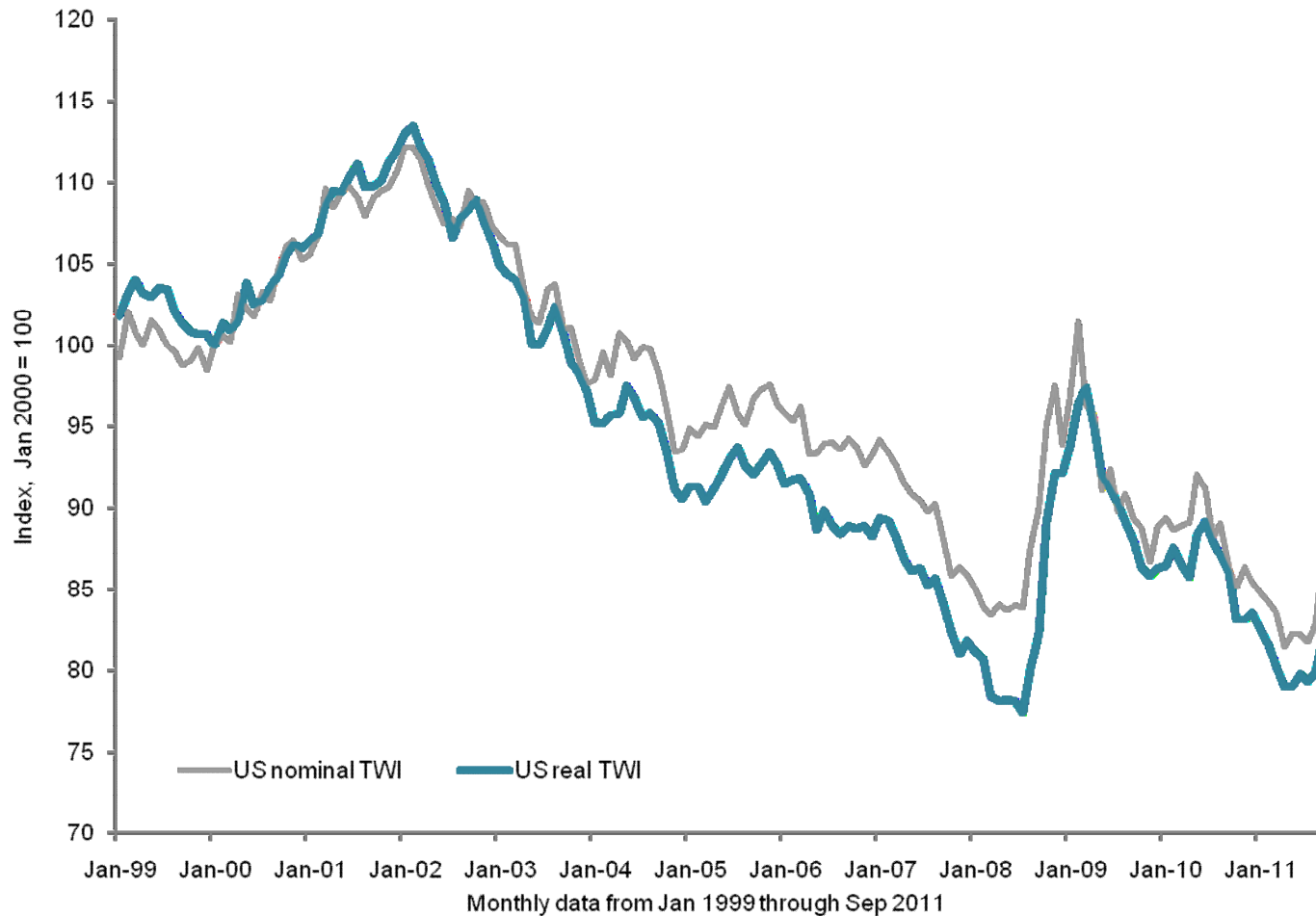
Inflation rates

Euroland



Trade-weighted exchange rate

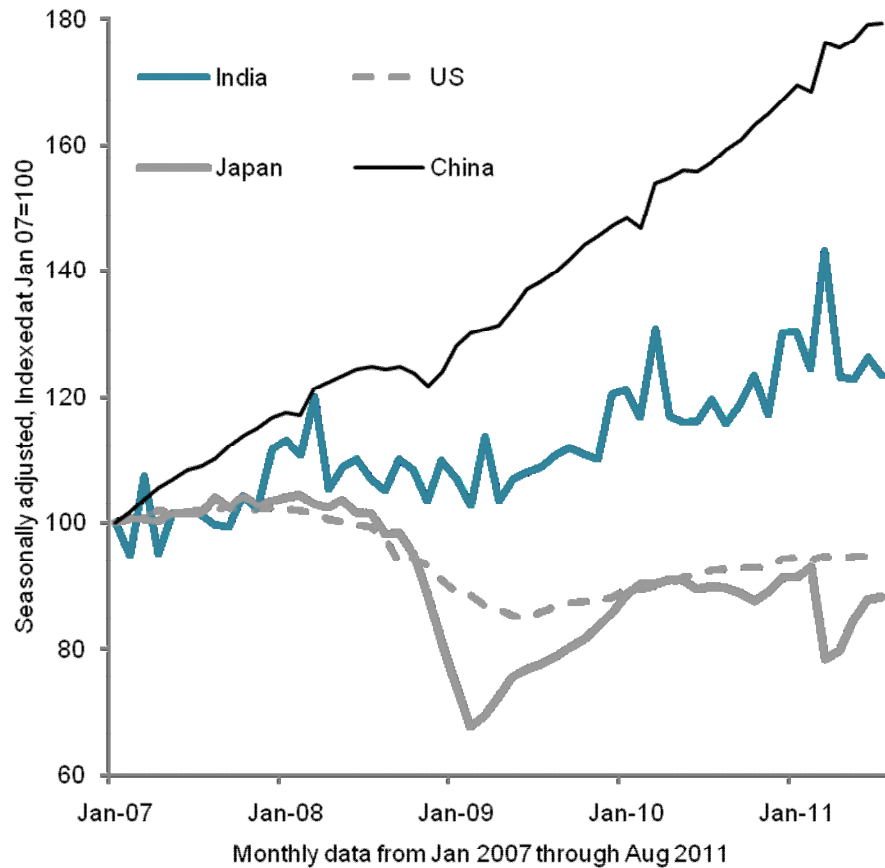
US



Review of Economic Environment

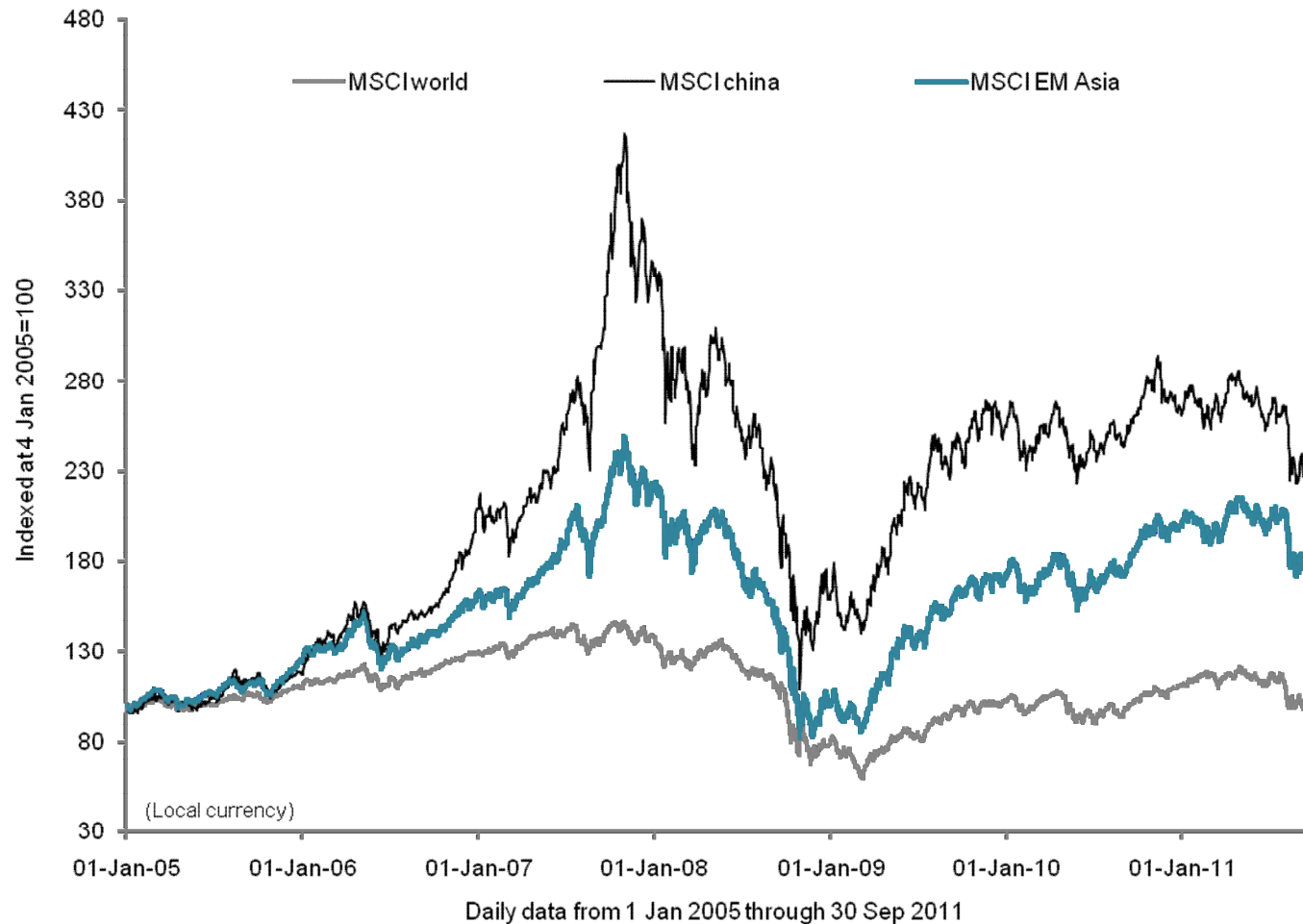
Asian Markets

Industrial production



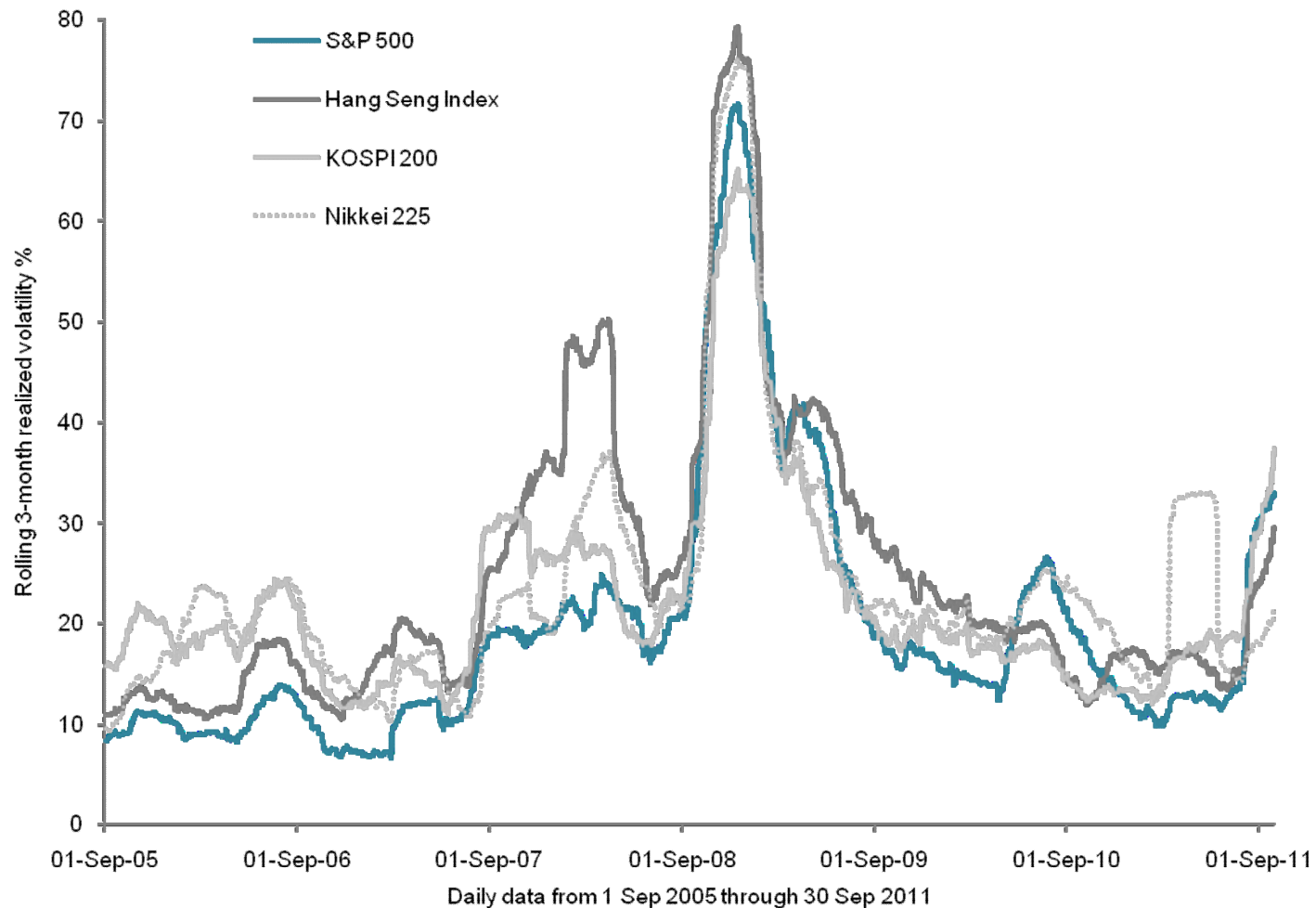
Stock prices

Asia



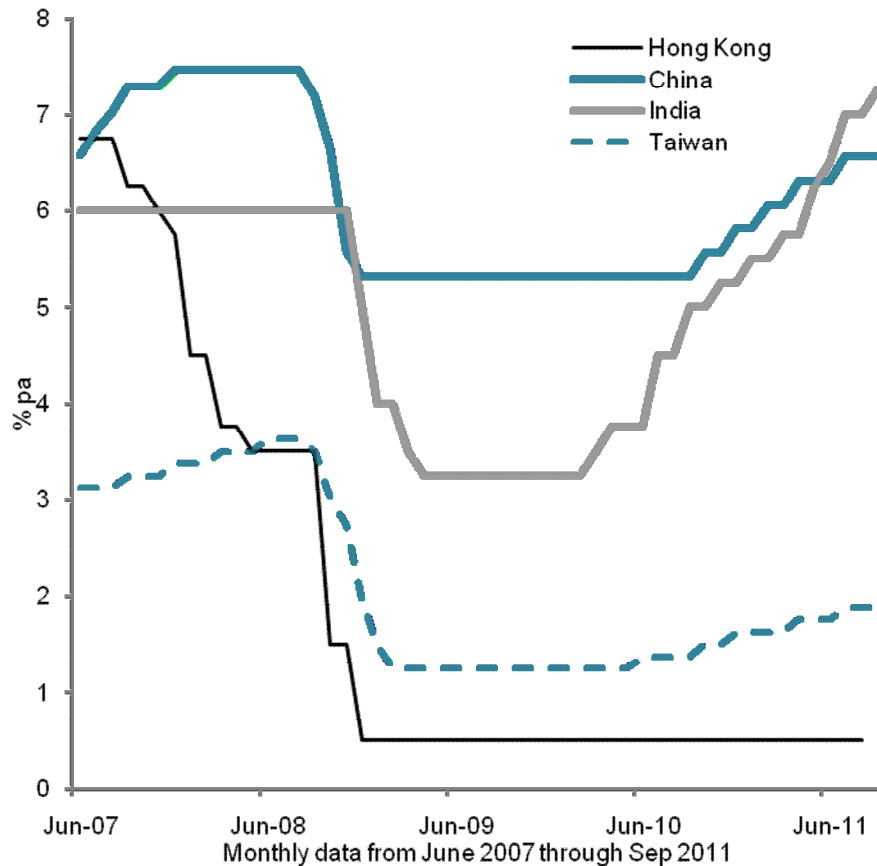
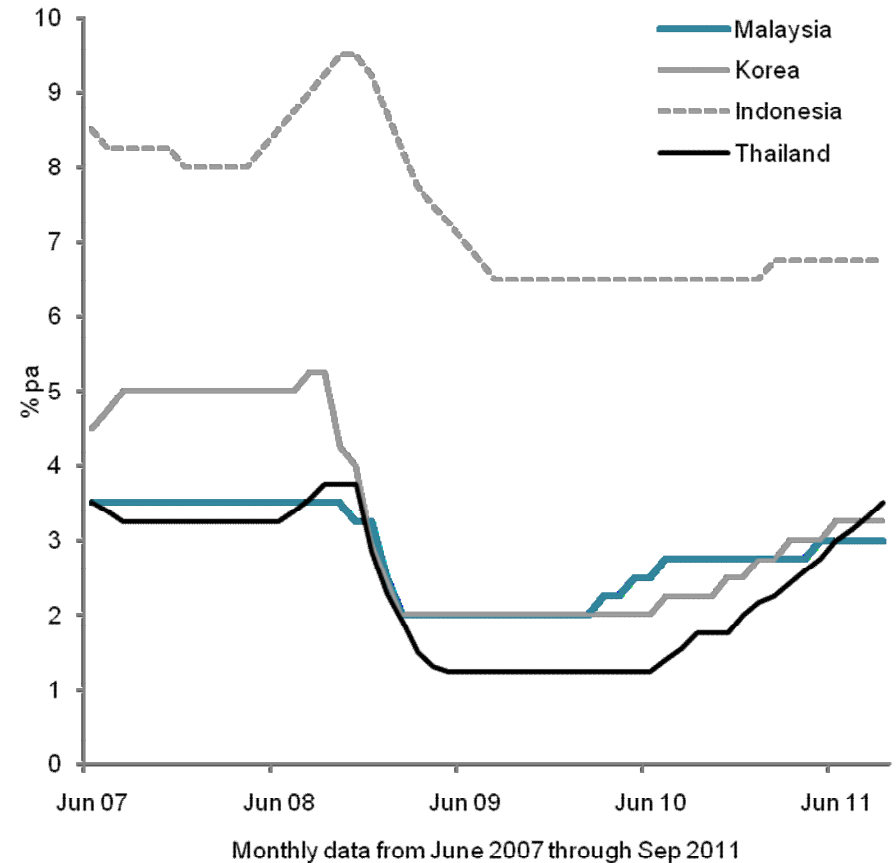
Realised volatility

Asia



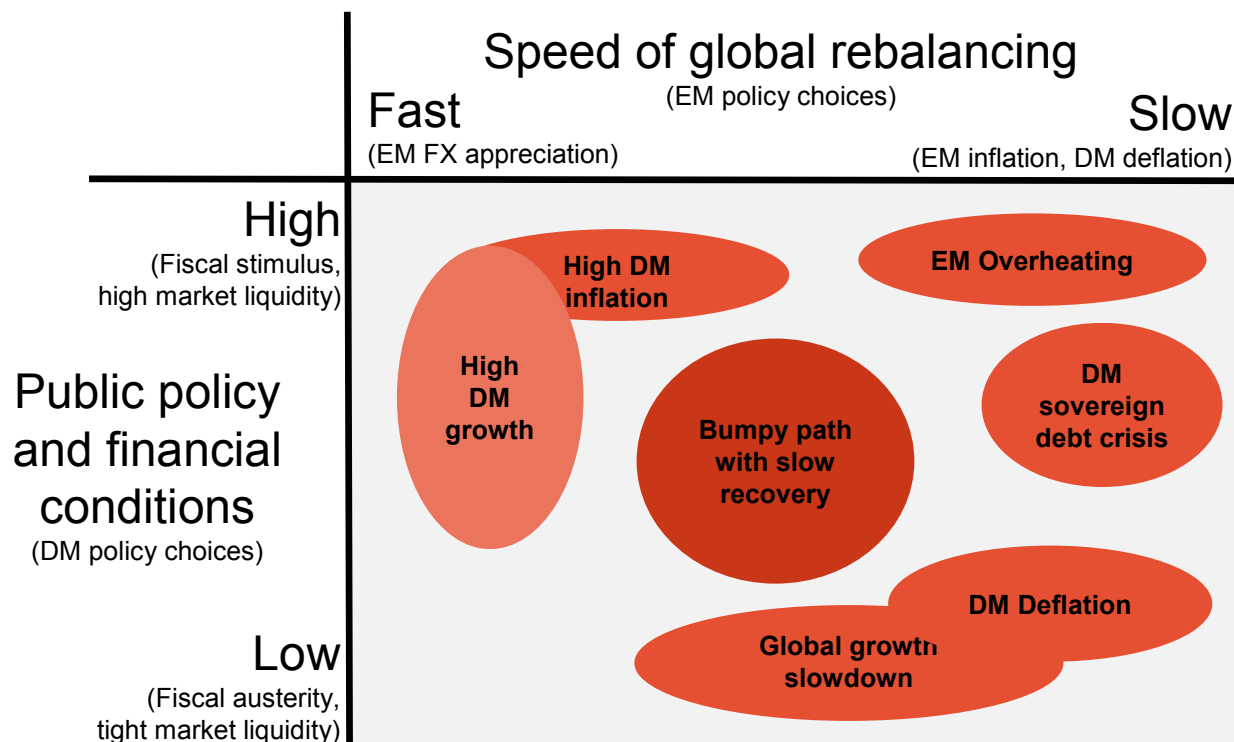
Policy rates

EM Asia



Some possible scenarios

Economic scenario illustration



EM: Emerging Markets
DM: Developed Markets

Scenario probabilities

Bumpy path with slow recovery	45%
Global growth slowdown	
DM Deflation	20%
High DM growth	
High DM inflation	10%
Major DM sovereign debt crisis and default risks	10%
EM overheating	15%

Scenario description

Economic scenario descriptions and asset class implication over the next three to five years

Bumpy path with slow recovery	<ul style="list-style-type: none"> • Sovereign and private debt concerns, as well as the fragility of the financial system, remain headwinds for DM growth but EM growth remains robust. As concerns transform into economic risks, investor risk appetite goes through large negative shocks • Equity and credit returns are positive, volatility is elevated. Government bonds weaken modestly and remain volatile.
Global growth slowdown	<ul style="list-style-type: none"> • EM demand fails to offset DM slowdown in the near term. Global growth remains sub-trend for an extended period. • Weak performance by DM and especially EM equities and credit, as well as commodities. Nominal bonds perform well.
DM Deflation	<ul style="list-style-type: none"> • Lack of demand in advanced economies – driven by large-scale global fiscal retrenchment and sharper debt deleveraging – cause an extended double-dip contraction in output and entrenched price deflation. • Very weak performance of equity and credit markets in DM. Sovereign nominal bonds significantly outperform.
High DM growth	<ul style="list-style-type: none"> • EM currencies appreciate making DM countries more competitive and improving their economic outlook. Employment and capital flows support the economic recovery and income generation allows for debt servicing and a gradual reduction of debt levels. • Very good for equities, credit, commodities and (especially) EM currencies. Weak for DM bonds
High DM inflation	<ul style="list-style-type: none"> • Temporarily, policy makers tolerate higher inflation driven by extended monetary stimulus. Risks remain that the scenario turns into hyper inflation in some countries. • Equities and commodities perform well in nominal and real terms. Nominal bonds are weak. G4 currencies are weaker.
Major DM sovereign debt crisis and default risks	<ul style="list-style-type: none"> • Excessive public sector spending increases concerns about the sustainability of balance sheets. Given the weakness of major banks' balance sheets, funding stress causes a tightening of credit conditions. Market concerns about the economic outlook increase. Debt crises enforce defaults and restructurings. • Weak equity and commodity performance. "Safe haven" DM and EM country government bonds outperform.
EM overheating	<ul style="list-style-type: none"> • Strong economic growth in EM countries, driven by domestic credit growth and loose monetary policy imported from abroad, creates very rapid EM inflation. EM policy makers are required to tighten their monetary policy strongly. • Weak performance of EM debt and equity. Potential spill-over to DM inflation but DM assets are less affected.

Implications for Actuaries

Low interest rates (1)

“Life insurers continue to be concerned by continuing low interest rates, as well as by the significant uncertainty about their direction. Recent analyst calls have cited lower profitability due to squeezed interest margins. The current economic environment and associated uncertainties about the future pose a number of challenges for life insurers.”

Towers Watson survey of US insurers

Low interest rates (2)

Role of the actuary

1. Guidance note GN L01
 - Suitability of premium rates
 - Financial Condition Investigation, including stress testing
 - Participating Fund allocation and bonus declarations
 - Investment policy and strategies
2. Broader responsibilities as a profession
 - Trust of policyholders and public (“reasonable expectations”)

Low interest rates (3)

Suitability of Premium Rates

- Non-participating spread/ savings products
 - How frequently are premium rates reviewed?
 - Are existing products creating unexpected risks or exposures?
 - In some cases, repricing is needed, but....
 - Issue with competitiveness/ attractiveness of the product if the level of investment guarantee is reduced.
 - Sales volume reductions vs expense load levels.
 - Interaction of investment strategies and product strategies.
 - Consideration of new designs?
- Products with investment guarantees
 - Impact of policyholder behaviour on cost of guarantees?
 - Use of stochastic modeling? Under a stochastic approach, the cost of guarantee will include the time value of guarantee in addition to the intrinsic value.

Low interest rates (4)

Suitability of Credited Interest Rates

- Universal Life

- Consider reducing credit rate on in-force business... but subject to minimum guarantees?
- Need to consider investment strategy (impact of corporate spreads)
- The company's solvency is more volatile during a low interest rate environment, when it is close to the minimum guarantee level. Why?
 - In a low interest rate environment, if the interest rate is lower than the guarantee minimum crediting rate, then the MCL will be greater than the GPV reserves.
 - The MCL will include the amount required to meet the cost of guarantee (i.e. the difference between the interest rate and the guarantee minimum crediting rate).
 - A change in the interest rate will have impact on two items, the discounting of the cashflows, as well as the level of cost of guarantee.
 - As a result, the solvency position is volatile during low interest rate environment.

Low interest rates (5)

Financial Condition Investigation

- Prescribed long term risk free discount rate
 - The “LTRFDR” for statutory valuation purposes is prescribed on a smoothed basis.
 - This is appropriate if fluctuations are short term and “revert to the mean”, but not if the trends are persistent
 - The smoothed rates would be higher than the current low interest rates. Reserves will not be sufficient to meet future cost if low interest rates persist for a long period of time. This is particularly an issue for savings/ spread products with very long duration like annuities and whole of life business.
 - When a company wants to adopt an investment strategy to closely match the assets and liabilities, the conclusion would be very different if the analysis uses statutory liabilities derived using smoothed rates as compared to an analysis uses policy liabilities derived using the current market interest rates without smoothing. What does your company use?

Low interest rates (6)

Participating Fund and Bonus Declarations

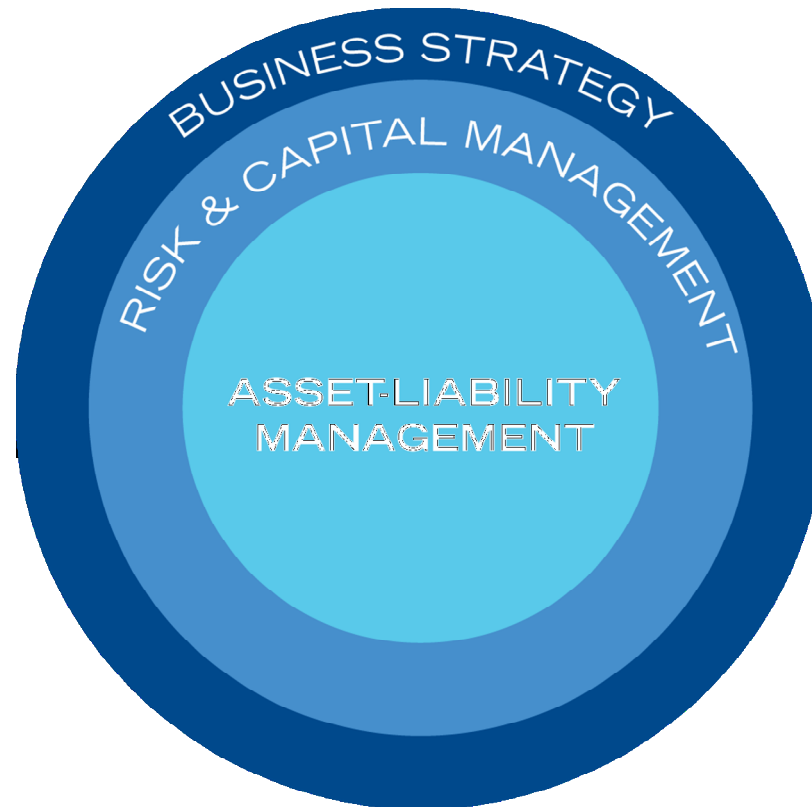
- Most existing business was sold during periods of high interest rates hence the illustrated bonus rates at point of sales are no longer supportable.
- Can we maintain bonus declarations at current levels?
- What level of “intergenerational transfer” is appropriate to support bonus declarations?
- Is the company’s smoothing method appropriate in a scenario of sustained low interest rates?
- What level of risk in the investment portfolio is required to support bonus expectations over the longer term, and is this consistent with risk appetites?
- Can the current illustrated investment return in the benefit illustration be justified?

Low interest rates (7)

Investment Policy and Strategies

- Setting investment strategies and managing Asset/Liability Risks
 - Is it the right time to match asset and liability? If this is done, while it reduces mismatching risk, the company will also lock into the current (low) rates.
 - In a recent survey of Insurance Companies in the USA:
 - Number one concern is dealing with persistent low interest rates
 - Second biggest concern...risk of rapidly rising interest rates
- Is this the time to consider introducing more “risky assets” into the portfolio?
 - Understanding risk appetite, governance structure

**ALM is an integral part of risk and capital management,
which in turn is driven by business strategy**



ALM – Typical management goals



ALM is not a static or one-time exercise. It is an ongoing process.

Low interest rates (8)

Broader responsibility of actuaries

- Ensuring policyholder reasonable expectations can be maintained
 - Understanding the expectations of policyholders and risks
 - Use of simple language and clear marketing
 - Reasonable balance of value to shareholders, distributors, and policyholders
 - Is the client's trust in our industry properly placed?

Volatility of equity markets

Some considerations:

- Suitability – for products that allow higher risk profiles, does your company have a process in place to test the suitability of client product choices?
- Transferring investment risk to policyholders may lead to more volatile sales levels – how will this impact the company?
- Volatile markets can also mean volatile market value and volatile fee income, as it is common that fees and expense loads are a % of fund value – are there plans in place to protect fee income or reduce expenses in declining markets?

Volatility of currency exchange

Some considerations:

- Investment policy: are you matching foreign currency investments to foreign currency liabilities?
- Consider other non-investment cash flows for matching?
- Can expenses be reduced by outsourcing? Does this introduce currency risks?
- How will volatility of currency exchange rates impact invested surplus, capital and profit from foreign operations?
- Consider the attractiveness of policies denominated in foreign currency (“policyholder expectations”)?

Volatility of inflation rate

Some considerations:

- Are a reasonable range of inflation assumptions being tested?
- Can products be easily enhanced or protection increased to respond to increased needs with inflation?
- For products with long term benefits (e.g. disability or long-term care), how are inflation risks managed? Are prices guaranteed?
- How will the company's investment portfolio react to a jump in inflation?

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