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Long Duration Liabilities – Unpriced Risks?

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Many companies have designed their life and annuity products with limited or no surrender benefits. Combined with young issue ages, companies feel they have reduced their interest rate risk by locking in their policyholders with limited liquidity. But are they inadvertently taking other risks? Companies with strong ALM practices will attempt to match a portfolio of long duration liabilities with an asset portfolio of comparable duration. Over the years fewer companies issuing debt have sought out maturities over 20 years. This has left insurers increasingly reaching out to securitized assets to back payout annuities, long term care, and whole life policies.

Securitized assets, primarily home mortgages, have served this long duration need. Insurers placed credit constraints on this portfolio, and long dated tranches were designed to fill the need. These types of assets were rated AAA by the rating agencies, and insurers worried about interest rate risk were now matched. With the recent deflating of the home bubble, this assumption should be reviewed. While the deals were over-collateralized, few imagined the level of credit risk taken. In the recent set of financial essays collected by the North American actuarial organizations, Louise Francis wrote about a method that uses loss triangles to estimate the ultimate default rate of mortgage pools. She estimates that over 60% of home mortgages in the US issued in 2007 will ultimately default. The Z-tranche assets, along with other tranches, have to be at risk. Insurers should review their own portfolios to determine how big an issue this is for them.

Financial Essays

I mentioned the collection of financial essays earlier in this newsletter. A total of 35 were accepted, and mine was accepted (I also published it as my December 2008 newsletter). I have read them all, and a few stand out for me. Each was written independently, so there is redundancy between them. Several do a nice job of describing the issues that drove the financial crisis. Others have technical solutions. Still others focus on culture. Mine notes the need to encourage someone to skeptically assess a company to help make better decisions. I will summarize several over the next several months

- Dave Ingram – What would your mother say?
    - Dave is the father of actuarial risk management, and I was pleased to see that he participated in the call for essays. His paper focuses on listening to your conscience, represented by his mother. If your mother found out what you were doing, or if it were announced to the public at large, would this create a problem for you?

The Next Shoe to Drop

The low price of oil has contributed to instability in several regions around the world. Although I am not supportive of regimes run by such "leaders" as Putin and Chavez, continued low oil prices would lead to violence and chaos in the regions of the world they influence. Mexico seems to also be precariously balancing right now. A 60 Minutes report on March 1, 2009 stated that drug money as well as weapons are coming from north of the border. If only the US middle and upper classes would curtail their use of drugs the world would be a safer place.

Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!