Impact of Low Interest Rates on Insurance Carriers and Brokers

High unemployment, a depressed domestic housing market and an economic downturn and debt crises abroad present significant head winds to economic growth.

The Federal Reserve announced in late January 2012 that it expects unemployment to remain high over the next three years. Consequently, the central bank is expected to keep interest rates near zero for that period.

This announcement – coupled with subsequent Federal Reserve announcements in mid-September 2012, a depressed domestic housing market and economic downturns and debt crises abroad – presents significant head winds to economic growth.

What does this mean to the institutional life insurance industry, brokers and associated administrative service providers? The purpose of this white paper is to provide some structure and context to help address this extremely vexing question.

IMPACT ON INSURANCE CARRIERS

A low interest rate environment presents three primary areas of concern for insurance carriers. They are:

INTEREST RATE RISK

Earnings spread compression is the most significant risk in a prolonged low interest rate environment. This essentially refers to the shrinkage of yield spreads, or the difference in yields between safe U.S. Treasury securities and comparably maturing investments, such as corporate, municipal and federal agency obligations and other asset classes, like real estate. It should be noted that insurance companies' investment choices are highly regulated and limited, which generally leads to safer and lower-yielding assets.

Insurance companies, through their new business issuance activities, normally provide some guaranteed rate of interest. As interest rates have come down, insurance companies must properly lock in a positive differential between what they earn on their investments (equities and bonds) and what they pay out on these contracts. Otherwise, there will be a mismatch between what is earned and what is paid. Since yields have been so low, companies are essentially starving for yield. This creates investment tension as carriers push as far out on the risk/return spectrum as possible, while respecting the need to balance their willingness to increase their risk for yield when there may be no perception that the risk is any lower.

This results in premiums, deposits, reinvestment of interest income and returns of principle on maturing fixed-income securities being placed into lower-yielding investments (short to intermediate treasuries), which will push net investment income down over time. In a prolonged low interest rate environment – in which rates remain consistently below

Current conditions are expected to make it challenging for brokers to sell general account BOLI products (Universal Life).

those that insurers assumed when they priced these products – the shortfall in investment income will lower earnings and probably negatively impact credit ratings.

CREDIT SPREAD VOLATILITY

Credit spreads are the premiums borrowers pay over risk-free rates. Essentially, if an investor (insurance company) wants a yield better than Treasuries, the borrower or issuer of the debt (typically bonds) must offer more yield to entice the purchase of such an investment. This is because the investment is generally perceived to be riskier than Treasuries.

This can have a significant impact on risk management through a variety of exposures, including use of interest rate swaps – typically a hedging device in which one party swaps a variable rate for a fixed rate and pays a certain amount for that hedge. Stable Value Wrap riders are a variation on this concept, although under current economic conditions, they are generally non-existent in the large case BOLI space, unless a carrier is choosing to self-hedge their portfolio.

DISINTERMEDIATION RISK

This is the risk that a policy owner will withdraw funds that are locked in at a low rate to instead invest at a higher new money rate. During the high interest rate days of the late ’70s and early ’80s, many clients with old whole life policies and guaranteed low loan rates borrowed the maximum loans and invested the monies in higher yielding money market accounts. In general, if an investor has monies in a low yield investment, like a fixed account, he or she might divert monies from accounts with low fixed interest rates to direct investment in high-yielding instruments. Such a scenario in insurance markets (1035 or surrender) could accelerate the pace of asset sales when such sales would likely produce financial losses.

IMPACT ON BROKERS

The effects of these areas on financial service providers (brokers) are equally impactful.

INTEREST RATE RISK

Since insurance products invest premium in “new” money and interest rates offered by insurance companies will continue to taper downward, the products offered may not be very attractive in a low interest rate environment. Brokers will likely find it challenging to sell general account BOLI products (Universal Life). With that said, banks are starved for yield, and even these low rates may be more attractive than the alternative. Andesa Services’ research indicates that BOLI sales remain consistent, albeit down from past highs. Pushing against this trend is the fact that carriers are preserving their existing policy holders and general accounts and are reluctant to take on new premium. Thus, insurers’ capacity to take on new business is becoming an issue of significance.

Pressures such as low interest rates, volatile equities markets and a political and regulatory environment in flux will continue to negatively impact the industry.

CREDIT-SPREAD VOLATILITY

Such an environment presents a potential reduction in use of Stable Value riders as an interest rate hedging tool. Therefore, large BOLI sales will likely be increasingly harder to achieve as general account yields continue to decline, since there will be a shortage of insurance companies with the financial capacity to issue new business in a low yield environment.

DISINTERMEDIATION RISK

In the event of an increase in surrenders or 1035 exchanges, business preservation will become an area of focus, as opposed to developing new sales opportunities. Our studies suggest that 1035 business remains active but appears to be tapering off, most likely due to surrender charges and similar events.

Likewise, when yields begin to rise, brokers will need to carefully monitor how quickly the carriers' portfolios yields will curve upward to follow the overall market. If the carriers are not responsive then existing business will be subject to further disintermediation risk.

CONCLUSIONS & CHALLENGES

Pressures such as low interest rates, volatile equities markets and a political and regulatory environment that is in flux will continue to negatively impact the industry. The current low level of interest rates significantly heightens the importance of strong enterprise risk management and asset/liability management.

Insurance companies and administrators have, as one of their key challenges, a need to develop an enterprise-wide risk management program to mitigate the impact of this low interest rate environment and set the stage for long-term growth. Fundamentally, these companies should ask themselves how they can maximize the spread between reoccurring revenue and cost of operations while reducing overall per-policy unit costs. This should be a key driver and an area of timely focus.

From a broker perspective, the current environment should result in a heightened focus on general account business preservation, increased diversification on carrier relationships and enhancement of general account products – like Indexed UL – to sell.

ABOUT ANDESA SERVICES

Andesa Services provides comprehensive, integrated policy administration, plan administration and support solutions for life insurance and annuity carriers and producers.

Andesa began as a pioneer in the field of COLI/BOLI policy administration. Today, more than 30 years later, we partner with seven of the top 13 life and annuity carriers and several top brokers. We offer a suite of SaaS and ASP services, all backed by decades of proven, practical expertise in the industry.

Andesa's highly experienced team of U.S.-based professionals is made up of devoted client advocates who help industry leaders save time, reduce risk and tap unrealized value.

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