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Weathering the Interest Rate Storm

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Yields on Treasury investments fell to very low levels in mid-June but rebounded subsequently. How well did insurers weather the storm and are there any lingering after effects? What is the reaction to the subsequent rate rebound?

The rates experienced in June were certainly low, but they were not unprecedented. In the early 1950s, short-term rates fell nearly as low and long-term rates were lower—10-year rate below 2.4 percent and 20-year rate at 2.6 percent. As Treasury yields fell during the first half of 2003, spreads on corporate bonds also fell, so investment yields fell as much as 1.0 percent. A seven-year A-rated corporate bond fell to 3.6 percent, while a BBB-rated bond fell to 4.0 percent. Ten-year A and BBB bonds fell to 4.1 percent and 4.6 percent, respectively. How did insurers react? In a disciplined fashion, it would appear.

The Growing Storm

In the early part of 2003, fixed annuity carriers were experiencing significant increases in fixed annuity sales, despite having reduced crediting rates. Contracts with a 3 percent minimum rate guarantee became attractive investment vehicles. Credited rates on fixed annuities exceeded those on certificates of deposit by a significant margin, fueling sales through the bank channel. Equity indexed annuity sales were booming, although a strong portion of the premium went into traditional fixed accounts in multi-bucket products.

Despite low credited rates, margins on fixed annuity products were being squeezed. Carriers found it difficult to support the credited rates guaranteed in their existing contracts. This led to actions to reduce the guarantees, whether by lowering the crediting rate guarantee while still using a 3 percent nonforfeiture rate or by taking advantage of the stopgap reduction of the nonforfeiture interest rate to 1.5 percent. Crediting rate guarantee reductions under the old nonforfeiture law were achieved by reducing the crediting minimum, generally to 2 percent for the first 10 years, an approach that still produces minimum contract values above the nonforfeiture minimum. However, although these steps gave insurers room to dramatically reduce credited rates, few took the actual credited rates below 3 percent.

As investment yields fell further and reductions of guarantees were insufficient or undesirable, commissions were cut in nearly every channel. Until recently, banks continued to demand historic compensation levels, but these also saw reductions. Commissions were dropped just enough to accommodate the spread compression from low interest rates.

In parallel with crediting and commission adjustments, many carriers began moving to the more aggressive end of their normal range of investment policy. Average investment grade moved moderately lower and asset durations lengthened to take advantage of the steep yield curve. Generally, this combination of actions allowed insurers to remain active in the market, although sales had to be discontinued for many multi-year guarantee products that allowed surrender charge free withdrawals at the end of the guarantee period, thus required short investment horizons, and for products not protected with adequate surrender charges.

Rates Rebound

The period of low Treasury yields was relatively brief, and rates rose 100-130 bps on three to 10 year Treasuries within six weeks, by early August. Although corporate spreads slipped by approximately 10 bps during this period, the available investment yields had increased dramatically. How did the annuity market react?

Credited rates began to rebound in August and have continued in September at levels that parallel the increase in investment yields, showing a strong sensitivity to market expectations. Although commissions were the last step in adjustments for low interest, they were not the first component to rebound, perhaps recognition that commissions had crept up in recent years and merited a more permanent adjustment.

Although investment yields have risen, insurer interest in utilizing lower nonforfeiture rates has not abated. This both strengthens solvency protection and creates an opportunity for higher crediting. The primary focus currently remains on the stopgap 1.5 percent law, because it is available in 33 states; while strategizing continues for use of the indexed nonforfeiture law, which has been adopted by only 12 states. A clear direction for utilization of the indexed law still awaits adoption of the model by more states and a clarification in the supporting regulation (under development at the time this article was written) of the degree of flexibility permitted in the determination of the nonforfeiture rate by the wording "Treasury Rate…as of a date, or average over a period…no longer than fifteen (15) months prior to the contract issue date…" This literally allows great leeway in setting nonforfeiture rates, but some constraints may be imposed.

There is some concern that as interest rates increase, fixed annuity products could be surrendered for better rates. Carriers may be protected since the affected products are newly issued and deep within their surrender charge period.

The steps taken by insurers as rates fell sharply and then rebounded showed a balanced approach to addressing the issue from all perspectives. The current position leaves insurers better prepared to provide value to customers than before the drop, and leaves them better positioned to protect their solvency if rates again drop. □

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