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Rising Interest Rates: How Big a Threat?

by Frank Sabatini

For writers of fixed annuities, the impact of rising interest rates largely depends on the speed with which rate hikes are implemented.

Now that the life insurance industry has survived one of the worst bear markets in history, along with the lowest interest rates in decades and another round in the credit cycle, will rising interest rates be the next risk management challenge for life insurers to overcome? Possibly. That depends on a number of factors, some of which are environmental and others that are company-specific.

The recent rise in interest rates—a nearly 2 percent increase from the lowest point as measured using the five-year treasury note—has given the industry some relief from its exposure to an extended period of very low interest rates. But now that the Federal Reserve has embarked on a long-anticipated round of rate increases, insurers are pondering the implications this will have for their business and profitability.

Impact on Annuity Writers

Rising interest rates undoubtedly present the greatest threat to writers of fixed deferred annuities. Deferred annuity crediting rates have been lingering at or slightly above contractual minimums for the past few years. Portfolio rates have declined to the point where some carriers have not been able to achieve their target spreads, resulting in depressed earnings.

To compound the problem, policyholders have come to the realization that the 3 percent minimum guarantee on fixed annuities is a fabulous deal in the current environment, and have therefore, held on to their policies. Some companies have stopped writing new business to avoid selling products with current credited

rates that cannot be supported by new investments. Almost all writers have lowered minimum guarantees to 1.5 percent or 2 percent.

Sustained levels of very low interest rates provide sufficient time for portfolio returns to decline further as higher-yielding investments on insurers' books mature and are replaced by investments with significantly lower yields. With the continuation of low rates, the gap between investment returns and minimum guarantees narrows even more. The rate at which this occurs for a particular company depends on its particular circumstances, but the most important factor is the extent to which there is a mismatch between the company's asset and liability durations.

Companies historically have purchased investments that have a longer life than the liabilities the company has acquired. Since longer-term investments often have higher yields, this practice has provided the annuity writer with either a greater profit expectation and/or a more competitive credited rate. However, as interest rates have fallen, the liability duration has become longer as the minimum guarantees have been reached, and policyholders have shown a greater tendency to keep their policies in force.

The historically low levels of interest rates have placed pressures on realized spreads that have been reflected in earnings results in recent years. Low interest rates work toward an insurer's detriment because they cause investments to mature more quickly and portfolio yields to decline more rapidly than liability rate changes, accelerating the spread compression caused by the minimum guarantees. To dampen the impact on spreads, many companies have maintained an intentional mismatch of assets and liabilities through the normal management of the asset portfolio.



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From this perspective, the recent rise in interest rates is actually good news for fixed annuity writers. The rise has produced higher investment yields on new investments without a corresponding increase in credited rates, resulting in improved spreads. The rates that annuity writers are crediting today still represent an attractive alternative to consumers, especially relative to certificates of deposit. Therefore, the rise in rates has benefited annuity writers.

It's Not How High, but How Fast

But what happens when interest rates rise suddenly? This situation last occurred in the late 1970s and early '80s, when interest rates rose quickly and dramatically. What occurred then could happen again, with a similar impact on annuity writers. At that time, the rise in rates outpaced the ability of existing investment portfolios to keep pace with credited rates seeking new deposits and supported by the current higher-yielding investments.

Companies had two choices. They could either subsidize existing credited rates to keep customers from leaving to get the higher returns, or they could suffer the financial consequences of losing the customer, including a loss of spread income and capital losses from having to liquidate existing assets at a loss to fund the departures. Often, the departing customer was funded by the arrival of a new customer, who got the higher crediting rate but was backed by the lower-yielding asset, thus constructively realizing the financial loss.

Back then, of course, we had double-digit interest rates. But it's not the level of rates that matters—it's the relationship between new money and in-force credited rates. Right now, new-money credited rates are close to 4 percent, and in-force policy credited rates are at the 3 percent minimums. This differential provides little incentive for existing policyholders to switch to a new contract, especially when many of them would have to accept a new surrender charge period to make the change. But a rapid rise in new-money rates will quickly change this dynamic.

The fact that significant portions of an insurer's annuity business are outside the surrender-charge period or carry a relatively small penalty for the policyholder would likely create even greater financial pressures for the insurer. Many existing policyholders would have to accept a new surrender-charge period to move to a higher-rate contract, but in cases where existing policyholders incur either no penalty or only a small penalty for withdrawing funds from their contract, there will still be a significant incentive to accept the new contract, unless access to the funds is a consideration.



For policies that were issued during the past few years and have significant withdrawal penalties still in effect, the issue is different. When the policyholder has to incur a penalty to receive the higher rate, the rate improvement has to compensate for the penalty fairly quickly to justify the contract change. Bonus-rate products are designed to address this issue for the policyholder, and the sheer existence of these products makes the insurer's exposure to an exchange even greater.

It's difficult to forecast how policyholders and distribution systems will respond as rates rise. However, as the gap between new-money credited rates and existing credited rates widens, the propensity for policyholders to exchange the existing policy will increase. Conventional wisdom, which is not supported by actual historical experience, has been that policyholders will begin to accelerate their movement to higher rates when the gap reaches 2 percent or more. As a result, it is believed that a further rise in interest rates of 1 percent to 2 percent would likely trigger increased lapsation unless credited rates were increased on in-force policies. An even more dramatic rise would accelerate the potential for disintermediation.

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Rising Interest Rates

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Unfortunately, insurers' ability to credit higher rates on in-force policies—and remain profitable—is limited by their returns on existing investments. A rapid rise in rates, e.g., over a 12-month or shorter period, would not allow portfolios to respond. Insurers then would be faced with the choice of subsidizing credited rates or allowing policyholders to leave. In contrast, a more gradual rise over several years could be manageable.

Different Results for Different Companies

The financial impact of a rapid rise in interest rates will be different from company to company, based on a number of company-specific factors, including the insurer's distribution system, balance sheet diversification, product line mix and asset/liability matching approach.

Balance sheet diversification. The financial impact will show up on the balance sheet as reduced earnings from either reduced spreads, as liability credited rates rise faster than portfolio earnings, or as spreads earned on a shrinking base as policyholders leave the company in pursuit of higher credited rates. In reality, the impact will be a combination of both effects. Insurers realize that policyholders will tolerate some gap and will manage in-force policy credits to mitigate departures without having to provide market rates to all existing policyholders.

Distribution system. An insurer's ability to retain existing policyholders is also tied to the distribution system that produced the business for the company. If the producers are independent, the insurer faces increased pressure to maintain in-force credited rates at competitive levels; otherwise, the business is likely to move rapidly. Distribution systems with greater loyal-

ty to the manufacturer are likely to tolerate a higher gap between market rates and in-force credited rates. Therefore, how a company responds to the higher-rate environment will be influenced by the distribution system's likely behavior.

Product line mix. The mix of a company's business will also play a role in determining the severity of the financial impact. Clearly, companies with diversified balance sheets will see a smaller effect. Many other products besides deferred annuities have interest rate sensitivity. Universal life and similar products would be most affected; however, the level of disintermediation with these products could be significantly lower. Other product lines, such as immediate annuities, traditional life insurance, long-term care and disability income, will actually benefit from the rise in rates. Finally, some deferred annuity writers have written market-value-adjusted (MVA) business with fixed-rate guarantees. This product design protects the company from disintermediation, although any ALM mismatch could negatively impact profitability.

Asset/liability matching. As noted above, the level of surrender charge protection also will have an impact on the financial implications of rising rates. In general, companies that have asset/liability mismatches of one year or greater will be more at risk than companies that have accepted a lower spread over the past few years to stay more closely matched.

In addition, some companies have implemented risk management programs designed to respond to the rapid-rise scenario by implementing derivatives-based and/or carefully designed strategies to mitigate the effects of a rise in interest rates. How companies have positioned their assets and liabilities prior to an interest rate hike, and the nature of the hedging strategies that are in place, clearly will have an impact on the financial effect they experience once rates begin to rise.

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Hoping for the Best ... Fearing the Worst

What should we hope for? A slip back to lower rates or a rapid increase in rates will present the industry with serious challenges. Margins would shrink in either scenario. The best scenario is that interest rates will stay where they are or rise gradually over time.

For those not wanting to risk an acceleration in upward rate movements, now would be a good time to evaluate investment and product management strategies that are designed to mitigate this exposure or respond as it emerges. The companies that are better prepared will produce better earnings in a rising-interest-rate environment. ♦



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