

Opportunities for Small Life Insurance Companies to Improve Asset Yields

By Mark Whitford

Executive Summary

Insurance companies are under intense pressure to maintain profitability in the face of increasing competition, low interest rates, increased regulations (Own Risk and Solvency Assessment (ORSA)), and the risk of high inflation. The liability duration of most insurers tends to be over 10 years, with some having liability duration over 30 years (long-term care). As companies look to make an interest rate spread off of the discount rate used in pricing, investment income plays a vital role in the profitability of insurers. In today's low-interest-rate environment, generating that necessary investment income has often resulted in companies having to increase their exposure to investment risk.

The goal of this article is to share ideas with small life insurance companies on how they can seek to increase their asset yield.

With bond yields lower than they have been historically, opportunities to invest for yield have diminished. If this trend continues, investment income levels could decline further unless risk tolerance levels are re-evaluated and the credit quality of investment portfolios is adjusted accordingly. High-yield corporate bonds, bank loans, securitized mortgages or income-producing equity securities may represent an attractive option for improving current income while remaining within a targeted risk spectrum.

As companies increasingly rely on income from investments to meet the challenges ahead, we suggest that the need for proper evaluation of the composition and risk level of their investment portfolios is becoming more urgent.

Risk-Based Capital (RBC)

First we begin our analysis of RBC. The importance of RBC ratios is twofold:

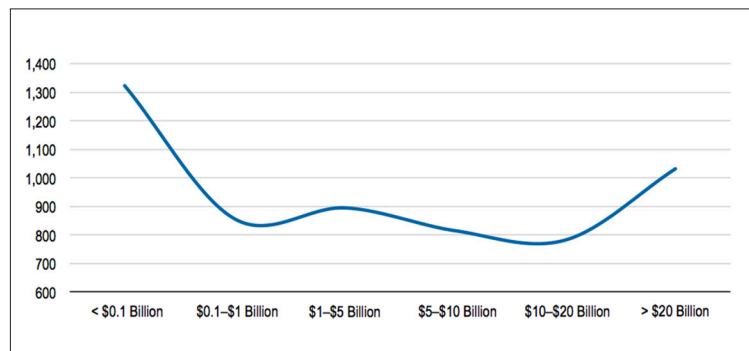
- Insurance companies must maintain a minimum amount of capital on the balance sheet to remain in business and avoid increased regulatory scrutiny.
- Comparing RBC ratios across a competitive set provides a measure of risk tolerance, particularly when evaluating a company relative to other insurers of similar size and type.

I suggest ample room exists to potentially increase investment income levels by selectively adding risk to investment portfolios.

As shown in Figure 1, RBC ratios as defined by invested asset base vary by company size and tend to drop as a company grows, except for the largest companies. There may be room for some small companies to take the RBC hit of going further out on the credit curve, resulting in increasing asset yields.

Figure 1: RBC Ratios According to Company Size

As of Dec. 31, 2013

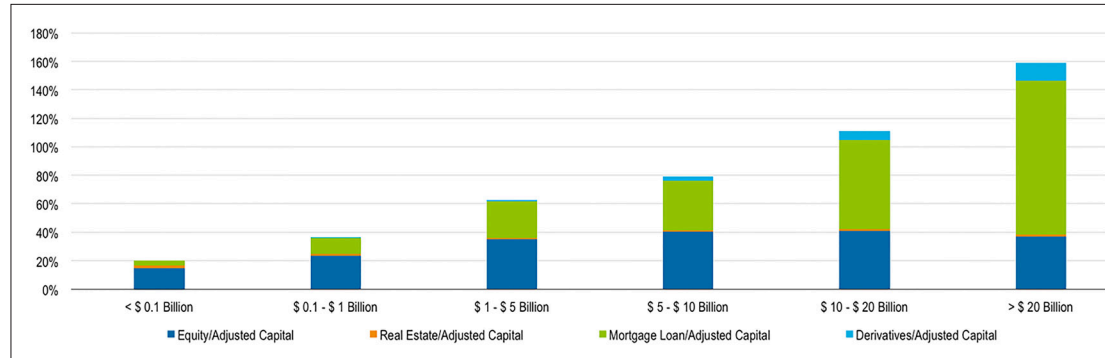


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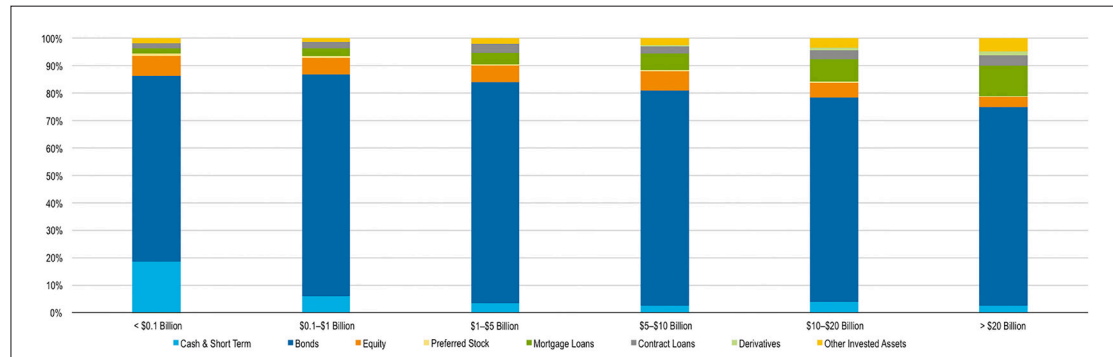
Figure 2: Proportion of Risk Assets as a Percentage of Capital and Surplus of L&A Insurers by Size
As of Dec. 31, 2013

As companies grow in size, they tend to increase allocations to riskier asset classes, appearing to demonstrate a preference for equity investments.



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Figure 3: Asset Allocation Profiles of L&A Insurers by Size
As of Dec. 31, 2013



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Asset Risk Analysis: Credit Risk

Credit risk can have a major impact on total investment returns for insurers, as was demonstrated in 2008 at the height of the global financial crisis.

I categorize risky asset classes as high-yield bonds, preferred and common stock, schedule BA assets and “other invested” assets. Figure 2 compares the percentage of surplus that insurers invest in these riskier asset classes. Here again there may be room for some small companies to increase investment yield by taking on more risky assets.

Asset Risk Analysis: Investment Risk Comparison

Insurance companies tend to hold less cash and maintain larger allocations to mortgage loans, contract loans and “other invested assets.” As the invested asset base increases, there tends to be a corresponding increase in allocations to riskier asset classes and a decrease in investment in cash and bonds.

In addition to evaluation of liquidity and credit risks, a review of investment portfolio composition also reveals several interesting themes. Figures 3 and 4 compare the asset allocation decisions of insurance companies by size.

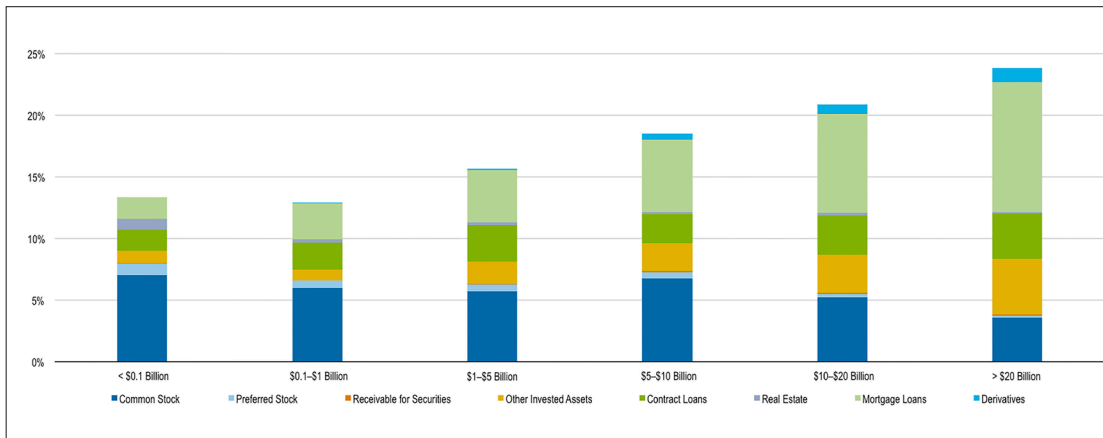
Asset Risk Analysis: Bond Allocations

Examination of bond portfolios in isolation provides further evidence of the relationship between risk tolerance and invested asset base (Figure 5). As the invested asset base increases, the allocation to National Association of Insurance Commissioners (NAIC) 1-rated bonds (AAA–A) declines, while the allocation to NAIC 2 (BBB) and NAIC 3-6 (high-yield) bonds rises.

Asset Risk Analysis: Maturity Allocations

Examination of bond maturity also provides further evidence of the relationship between risk tolerance and invested asset base (Figure 6). As the invested asset base increases, the allocation to longer-maturing assets increases. I can see a decrease in allocation to maturities less than five years and an increase in the 10-plus maturity bucket.

Figure 4: Asset Allocation Profiles of L&A Insurers (Excluding Cash and Bonds)

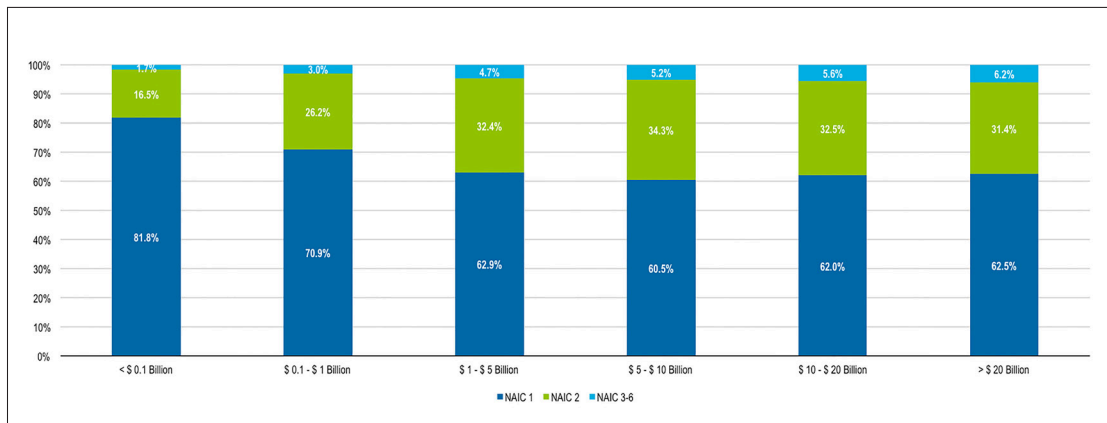


Larger companies appear to have a greater tolerance for holding more illiquid assets.

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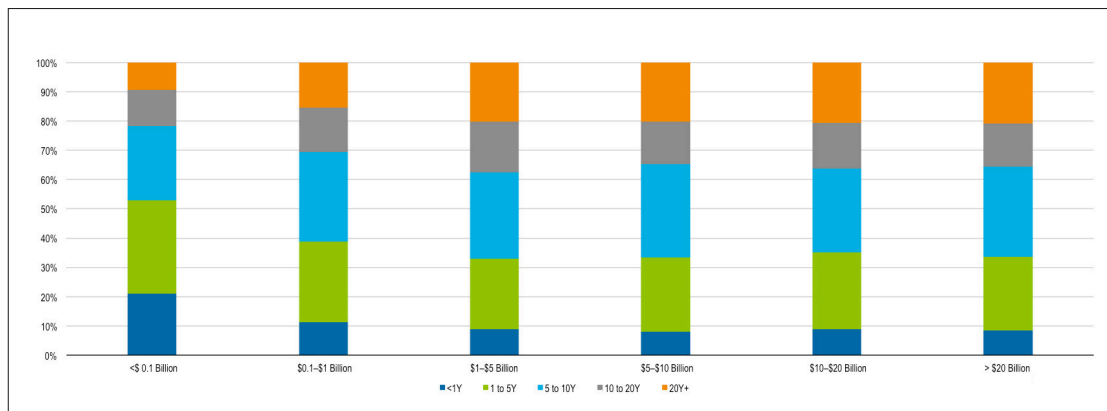
Figure 5: Distribution of Holdings by Bond Ratings for L&A Insurers by Size

As of Dec. 31, 2013



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Figure 6: Maturity as % of Bond Portfolio



As the invested asset base increases, the average portfolio maturity tends to increase.

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In Search of Yield

Recent capital market trends may drive further changes in asset allocation decisions and risk tolerance levels. With the exception of the 2008 crisis period, overall bond yields have declined meaningfully over the last decade, and opportunities to invest for yield have diminished. Looking at Figure 7, we can see smaller companies' net yield has been impacted more by the low-interest-rate environment than larger companies' has. Prior to 2008, an AAA-rated security yielded approximately 4 percent; today, that same security would yield closer to 2 percent. If this trend persists, we believe investment income levels could continue to decline unless risk tolerance levels are re-evaluated and the credit quality of investment portfolios adjusted accordingly.

Insurance companies seeking to boost investment income in an environment of diminishing yields may benefit from a shift in asset allocation to potentially higher-yielding opportunities, such as high-yield corporate and municipal bonds, bank loans, select opportunities within mortgage-backed securities (MBS) or income-producing equity securities. Such assets may produce yields ranging from 3.5 percent to over 7 percent, though they bring with them a higher risk profile. One other area that has been gaining traction lately is NAIC-rated funds. As small companies may have trouble investing in certain asset classes, on a separate account basis, funds make sense since they can invest a smaller amount and still get the diversification as a larger allocation. Rated funds help change the rating from a high equity factor to a lower factor (NAIC 1-4). As we move forward, our expectation is to see an increase in the number of rated funds. We believe the higher-yielding asset classes we have discussed may represent an attractive option for improving current income while remaining within a targeted risk spectrum and providing additional potential diversification benefits. To learn more about rated funds, feel free to contact me or ask your current investment manager for a list of rated funds.

Conclusion

Insurance companies have accumulated huge amounts of assets. Those assets are mainly invested to match the obligations to millions of policyholders. The investment performance of those assets not only contributes to an insurer's profitability, but also to its competitiveness and growth of capital.

Against this backdrop of increasing pressure on margins spurred by growing competition and regulatory changes,

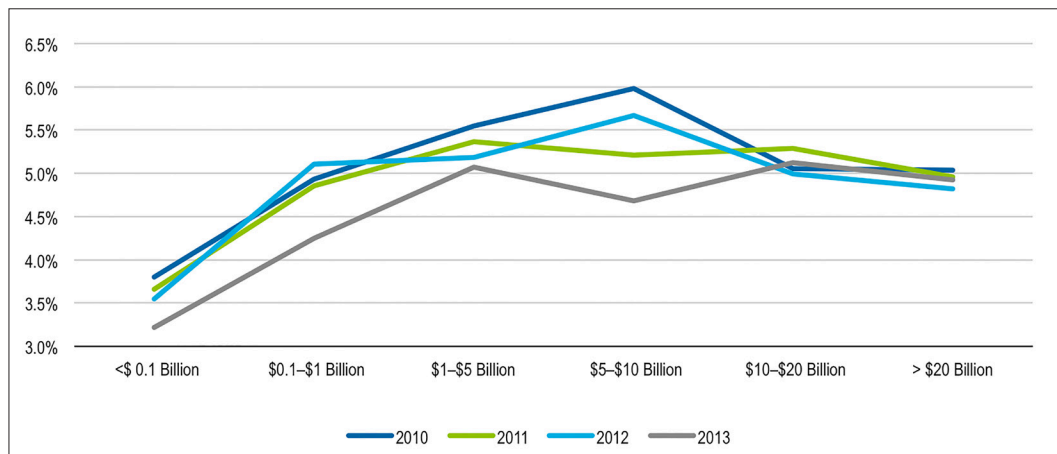
insurance companies face the challenging task of improving margins while maintaining appropriate liability coverage and capital ratios.

As companies rely more on income from investments, we expect the need for proper evaluation of the composition and risk level of investment portfolios to become more urgent. Our analysis has led us to believe there is an opportunity to increase profitability by selectively adding risk to an insurer's investment portfolio. The process of balancing the drivers of both assets and liabilities can be challenging.

A WORD ABOUT RISKS

High-yield debt securities (including loans) and unrated securities of similar credit quality ("high-yield debt instruments" or "junk bonds") involve greater risk of a complete loss of an investment, or delays of interest and principal payments, than higher-quality debt securities. Issuers of high-yield debt instruments are not as strong financially as those issuing securities of higher credit quality. High-yield debt instruments are generally considered predominantly speculative by the applicable rating agencies as these issuers are more likely to encounter financial difficulties and are more vulnerable to changes in the relevant economy, such as a recession or a sustained period of rising interest rates, that could affect their ability to make interest and principal payments when due. If an issuer stops making interest and/or principal payments, payments on the securities may never resume. These instruments may be worthless and an investor could lose its entire investment. The prices of high-yield debt instruments fluctuate more than higher-quality securities. Prices are especially sensitive to developments affecting the issuer's business or operations and to changes in the ratings assigned by rating agencies. In addition, the entire high-yield debt market can experience sudden and sharp price swings due to changes in economic conditions, stock market activity, large sustained sales by major investors, a high-profile default, or other factors. Prices of corporate high-yield debt instruments often are closely linked with the company's stock prices and typically rise and fall in response to factors that affect stock prices. High-yield debt instruments are generally less liquid than higher-quality securities. Many of these securities are not registered for sale under the federal securities laws and/or do not trade frequently. When they do trade, their prices may be significantly higher or lower than expected. At times, it may be difficult to sell these securities promptly at an acceptable price, which may limit an investor's ability to sell securities in response to specific economic events or to meet redemption requests. As a result, high-yield debt

Figure 7 : Net Portfolio Yield for L&A insurers by Company Size



Larger companies' net yield has not been impacted as much from the low-interest-rate environment as smaller companies' has.

instruments generally pose greater illiquidity and valuation risks. Substantial declines in the prices of high-yield debt instruments can dramatically increase the yield of such bonds or loans. The decline in market prices generally reflects an expectation that the issuer(s) may be at greater risk of defaulting on the obligation to pay interest and principal when due. Therefore, substantial increases in yield may reflect a greater risk by an investor of losing some or part of its investment rather than any increase in income from the higher yield that the debt security or loan may pay to an investor on the investment. ●

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