A Case of Low Book Yields

By Kerry Pechter *Fri, Nov 1, 2013*

"Even if rates were to slowly rise, they would still be historically low. There would be less pressure on companies, but the overall portfolio rate of return could continue to go down," said Mary Pat Campbell, a life insurance investment analyst at Conning.

The "overall downward trend" in book yields of U.S. life insurance companies "presages challenges ahead," according to the twelfth and latest edition of the review of life insurance company investments and returns that Conning's Insurance Research group has published since 2001.

The review, titled "Life Insurance Industry Investments: A New Perspective on Asset Allocations and Returns," described the investable assets of 470 U.S. life insurers, who collectively earned $177.5 billion on assets of $3.2 trillion in 2012, down from earnings of $178.9 billion on about $3.16 trillion in 2011.

One takeaway: The effects of low rates will persist, even after rates begin to rise.

Conning provided *RIJ* with a 16-page executive summary of the 131-page report. The information below is based on the summary and on a telephone interview with its author, Mary Pat Campbell. The names of individual life insurers didn't appear in the summary.

Regarding the life insurance industry as a whole, the review's outlook for the future was subdued. With some 85% of its investable assets in bonds, the industry is especially vulnerable to low bond yields. Overall book yields for life insurers hit an all-time low of 5.24% in 2012, which in turn has maintained downward pressure on life insurance company stocks, making it more difficult for them to raise capital and encouraging stock buy-backs.

Looking at the bond portfolio alone, "Gross book yields… (including cash, short-term bonds, and long-term bonds) decreased by 21 bps in 2012 to 5.01%, 72 bps lower than the yield in 2008," the report said. "Realized capital gains and positive change in unrealized capital gains and losses, together with investment income, caused the total return for bonds to decrease to 7.54% in 2012, less than the gross total returns seen from 2009 to 2011."

But the averages mask a wide range of differences in the health of individual life insurers. The industry is made up of more than 200 companies with less than $100 million in assets while the biggest 50 or so companies account for some 83% of the industry's investable assets, according to the Conning report.

Larger companies tend to have larger, more sophisticated research capabilities that enable them to shop more confidently among riskier but potentially higher-yielding investments in hedge funds and other so-called Schedule BA assets. In 2012, insurers with at least $20 billion in assets held about 90% of the industry’s Schedule BA assets, and just seven large life insurers held 60% of those assets.

One limitation of the report: it doesn’t cover the other side of the insurers’ balance sheets, their liabilities. Liabilities range widely from company to company depending on the types of products it has sold over the past decade. Some insurers, for instance, have large books of under-risky variable annuity contracts. Others may have books of long-term care policies and second-guarantee universal life policies whose prices were based on over-optimistic lapse estimates.

“Some life insurers are doing much better than others,” said Mary Beth Campbell, the author of the review. “The results used to be a lot closer but now they’re spreading out.” The health of life insurers today depends to some extent on how they reacted to the financial crisis of 2008. “Some companies reacted to the financial crisis by fleeing into Treasuries and cash and didn’t get out of that,” Campbell told RIJ this week.

“Others have been actively seeking yield and explicitly taking on portfolio risk in the portfolio. They went after bonds of lower credit quality, primarily the BBB and not below-investment grade.”

Companies also differed in their reactions to the Federal Reserve’s low interest rate policy, with some continuing to offer products with underpriced benefits in the belief that rates would quickly recover and others recognizing that a low rate environment could last indefinitely—which turned out to be the right call.

“Some companies were in denial about the low rates. But if you didn’t think that low rates could last for a long time, you weren’t paying attention. Japan has been in that scenario for 20 years,” Campbell said.

Regardless of what happens to rates next year, the residual effects of low-rates will be felt for years to come. “Even if rates were to slowly rise, they would still be historically low,” Campbell told RIJ. “There would be less pressure on companies, but the overall portfolio rate of return could continue to go down,” she pointed out.

“We’ve been in a decreasing rate environment for quite a while. As older, higher-yielding assets have rolled off, newer, lower-yielding assets have replaced them. That process continues to pull down overall portfolio return rates. It could take a while before the life industry recovers.”

Companies have responded by not locking themselves into generous guarantees. Campbell said that more insurers are selling market-value adjusted fixed annuities to protect against a surge in surrenders as rates rise, variable annuity issuers are putting equity hedges inside the separate account portfolios, and crediting rates on universal life policies continue to fall.

On the other hand, life insurers won’t capture a big share of the retirement market from mutual fund companies unless they can offer attractive products. If and when rates rise, competitive pressures may compel them to share the newfound yield with customers by matching new higher-paying liabilities with new higher-paying assets.

“Life insurers still need to compete,” Campbell told *RIJ*. “Fixed annuities, for instance, have to compete against CD rates. What may happen is that crediting rates on in-force business may go down, but, as rates rise, new products might offer better rates. [Life insurers] can segment their portfolio. Their ability to offer new products [at new rates] would still be limited by capital constraints, and that may be one reason why they’ve been building up capital.”