Insurers should be wary of sharp rate hike: A.M. Best

By Editorial Staff *Thu, Apr 26, 2018*

Disintermediation risk, increases in hedging costs and capital strain due to reversal of unrealized gains could strain insurers, the rating agency warned.

A slow, smooth increase in interest rates by the U.S. Federal Reserve would allow life insurers/annuity insurers—especially those with minimal surrender protection or unattractive living benefits—to adjust crediting rates on existing products, reshape portfolio durations and help maintain credit quality for an optimal return, says a new A.M. Best special report.

But a sharp rise in increase rates could pose challenges to both sides of the balance sheet, the rating agency's analysts added.

The Best's Special Report, "Abrupt Interest Rate Hikes Could Pose Challenges to Life Insurers," observes that the yield curve continues to flatten. The Fed's recent rate hikes have lifted short-term interest rates but longer-term yields have been slower to respond.

For insurers with more spread-based liability profiles, that reduces the incentive to match durations and creates the potential for asset-liability management (ALM) mismatches.

In addition, insurers have lengthened their bond portfolios in pursuit of yield. Bonds with longer durations are more sensitive to changes in interest rates, so upside interest rate shocks could lead to a jump in market value losses on asset sales as lapses increase. (Allocations to bonds maturing in less than five years are at their lowest point in nearly two decades.)

A rapid rise in rates also could tempt owners of spread-based products to switch to competing products, such as bank certificates of deposit, that offer higher returns based on current rates.

The resulting increase in surrenders could force insurers to realize losses on their corresponding bond portfolios, thus weakening their liquidity and financial profiles. Insurers with minimal surrender protection or unattractive living benefits would be most affected.

Life/annuity insurers with well-established and effective ALM programs are best equipped to navigate a rapidly rising interest rate environment after a prolonged period of low rates.

The use of sophisticated enterprise risk management techniques can enhance life insurers' ability to monitor asset-liability positions through cash flow analysis, duration, convexity, earnings and capital at risk.

Interest rate moves are difficult to predict, and disintermediation risk, increases in hedging costs and capital strain due to reversal of unrealized gains potentially could lead to rating concerns. A.M. Best believes insurers will have to carefully navigate the environment over the next few years, regardless of the direction interest rates follow.