Interest rate drought not over: A.M. Best

By Editorial Staff *Mon, Jan 23, 2017*

'While aggregated industry bond portfolio yields have consistently declined to 4.71% in 2015 from 4.88% in 2014 and 4.99% in 2013, strategic investment decisions have helped mitigate further declines in book yield,' the ratings agency said in a special report.

The low interest rate environment will likely remain a challenge for the life/annuity (L/A) insurance industry in 2017, as companies continue to invest new money and the proceeds of richer maturing assets into new bonds at current rates, according to A.M. Best.

A new *Best's Special Report*, "Shifts in Bond Portfolio Strategies Help Life/Annuity Insurers Navigate Low Interest Rates," notes that bond portfolio yields have continued to decline. The Federal Reserve's 25 basis point rate hike in December 2016 was only the second hike in the last decade.

Reinvestment risk remains a key issue. Holdings have been reinvested at lower rates since 2012. While aggregated industry bond portfolio yields have consistently declined to 4.71% in 2015 from 4.88% in 2014 and 4.99% in 2013, strategic investment decisions have helped mitigate further declines in book yield.

If bond portfolio allocations had remained static as of year-end 2012, the industry's bond portfolio yield would have declined to 4.54% in 2015 from 4.86% in 2013, a difference of 10 to 20 basis points in each of the last three years.

Private placement bonds have surged by 70%, to $847.0 billion in 2015 from $497.3 billion in 2005. Private placement bonds are in limited availability and require a lot of expertise to manage. Only about 60% of L/A insurers held them as part of their bond portfolio as of year-end 2015. Insurers with investment portfolios greater than $10 billion held all but 4% of private placement bonds.

Companies also have increased the duration of their overall bond portfolios. A.M. Best said. Average maturities have increased to nearly 11 years since 2013, after sitting at less than 10 years prior to 2010.

Unless rates rise, insurers will need to find higher yields in order to maintain operating profitability and manage spread compression. The trends of investing lower on the credit scale, lengthening portfolio durations and increasing allocations to alternative fixed income assets such as private placements are well underway.

A.M. Best's said it believes that "by introducing products with lower risk characteristics into an older in-force block of business, L/A insurers may be able to maintain, perhaps at lower levels of profitability than in years past, a buffer against the continued low rate environment and declining yields."