Retirement Income
JOURNAL

New report from Fitch Ratings on interest rate climate

By Editor Test *Thu, Jul 18, 2013*

This news item, which summarizes Fitch's "Good, Bad and Ugly" scenarios for future interest rate movements, contains a link to a copy of a new Fitch report, "Heightened Interest Rate Risk for U.S. Life Insurers."

Fitch Ratings has released a special report that examines the challenging interest rate environment for U.S. life insurers. “While the recent uptick in interest rates has provided some relief to the industry, Fitch believes that the industry remains exposed to heightened interest rate risk,” the report said.

Fitch performed sensitivity analysis to look at the industry’s exposure to various interest rates scenarios. The scenarios, deemed The Good, The Bad and The Ugly, show that industry earnings are sensitive to future rate movements over a three-year projection period. A Fitch release described the scenarios as follows:

Good scenario

The Good scenario is a steady rate increase of 100 basis points per annum. This scenario is favorable across all major product lines and particularly interest-sensitive products such as fixed annuities, universal life and long-term care. Rising interest rates would have a positive impact on net investment income and interest margins and mitigate potential statutory reserve strengthening associated with asset adequacy testing. The interest rate environment thus far in 2013 is consistent with this scenario as the 10-year Treasury rate increased 74 basis points during the first six months of the year. Under this scenario, rating implications would be neutral to somewhat positive.

Bad scenario

The Bad scenario is level interest rates (from year-end 2012 levels) for three years. This scenario is unfavorable across all major product lines. Over the next two years, the impact of sustained low interest rates would limit earnings growth, but not have a meaningful impact on statutory capital. The impact on net investment income and interest margins will become more pronounced as the industry moves into the back half of the three-year projection period and beyond. Under this scenario, rating implications would be neutral over the near term but would turn negative if interest rates remain low much beyond 2014.

Ugly scenario

The Ugly Scenario is an interest rate spike of over 500 basis points, similar to that experienced in the late 1970s and early 1980s. This would have a more immediate negative earnings and capital impact due to heightened investment losses tied to asset sales needed to fund policyholder disintermediation associated with fixed annuities and other surrenderable liabilities. Under this scenario, rating implications would be negative.