Six Ways Insurers Can Fight Low Interest Rates

By Editor Test *Tue, Nov 8, 2011*

While forecasting a 10% decline in investment yields for life insurers due to Fed interest rate policy, Ernst & Young proposes six strategies firms can use to combat the impact of low rates. E&Y's Doug French (pictured) spoke with RIJ.

Low interest rates could cost large U.S. life insurers an average of 51 basis points in investment income over the next three years, or about 10% of their average income yield in 2010, according to a new study by Ernst & Young.

The study, "The impact of prolonged low interest rates on the insurance industry," was written by Doug French, Richard De Haan, Robb Luck and Justin Mosbo and released in October. It was based on an analysis of the top 25 life and top 25 property/casualty insurers.

Though substantial, the projected decline was less than the 68 bps drop in yield that E&Y estimated life insurers suffered since the financial crisis. "As we go to press [in October]," the report said, "the market turmoil has pushed the 10-year rate down to a new record low of 1.72%, compared with an average of 2.70% in August 2010 and 3.59% in August 2009."

"A 10% decline in yield is significant, and it goes right to the bottom line," said French, a managing principal in Insurance and Actuarial Advisor Services at E&Y. Even if insurers try to maintain profit margins by raising prices and reducing benefits more or less in unison, they will still face the headwind of a weak economy. "It's hard to raise prices to the end-consumer when you have a 9.1% unemployment rate," he said.

The identities of the insurers studied were not revealed. Projected declines in yields varied among the 25 life insurers, from under 10 bps to almost 70 bps. The impact of the decline, as measured by difference from 2010 yields, also varied widely from one insurer to another.

Nineteen of the life insurers studied were public companies and six were mutual companies. The average expected yield decline was higher among mutuals (59 bps) than among public companies (48 bps). French attributed the difference to the fact that "the mutuals have been selling a lot of business in the last few years. They've done really well."

E&Y suggested that insurers might explore mitigating low interest-rate risk through:

• In-force management—Identify and, where appropriate, pull the levers on in-force blocks to help offset declining investment yields. This includes **reducing interest crediting rates** and **policyholder dividends**, **limiting premium dump-ins** and possibly **adjusting premiums, product charges or commissions**, to name a few. However, this is subject to contractual guarantees, policyholder behavior, market, reputational and legal considerations.

• **Re-price products**—pricing products to reflect the current investment environment mitigates the risk for new business flows. However, this is subject to a number of competitive constraints and impacts to management production targets. The market remains very competitive, and whether decreased levels of investment income will be passed on to policyholders, absorbed by the companies or a combination of both remains to be seen.

• Change product mix—**refocusing sales efforts on products that are not heavily dependent on investment income** to meet profitability targets will help reduce the impact from new business flows.

• Cash flow management—**using cash inflows to pay cash outflows minimizes the amount of reinvestment over the short term and delays the impact on portfolio yield.** However, this may just mask the real economic losses; it is not a long-term solution and is subject to asset allocation, asset-liability management (ALM) and liquidity considerations.

• Increase asset duration—**investing in longer-term assets** offers the potential for additional yield and proper ALM as liability durations extend. However, duration mismatching over extended periods will increase risk, and long-term interest rates are at near-historic lows too, with the 30-year treasury rate at the time of writing at 2.79%.

• Increase allocation to risky assets—**increasing investments in lower credit-quality assets or alternative asset classes** may lead to higher expected yields. But it comes with additional risks. It may not make sense on a risk-adjusted basis and is subject to additional capital requirements, investment limitations and liquidity constraints.