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INSTITUTIONAL LIFE PORTFOLIO CREDITING RATES

What to Expect When Interest Rates Rise

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INTRODUCTION

Since the economic turmoil of 2008 that sent interest rates to historic lows, Institutional Life Insurance (General Account) gross crediting rates have enjoyed tremendous, positive spreads versus current market interest rates. The result has been favorable yields for Institutional Life policy owners, especially for Credit Unions, considering the restrictive investment parameters of Rule 703 applicable on the permissible investment side.

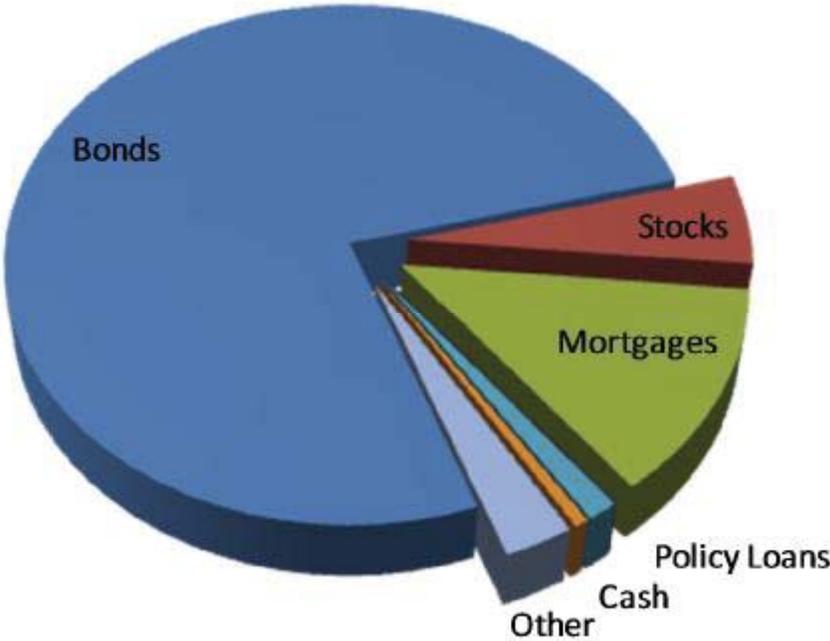
The extended period of low interest rates has had a persistent effect on Institutional Life crediting rates, however, as crediting rates have declined by about 30–40 bps each year since the “financial crisis” began. Despite this prolonged decline in crediting rates, Institutional Life rates continue to provide a meaningful spread compared to permissible assets. As the United States attempts to climb out of the “great recession”, policy-owners may be wondering...when will crediting rates stabilize and how quickly will they increase relative to market interest rates?

The following abstract provides: (i) a brief overview of the typical general account portfolio backing Institutional Life crediting rates; (ii) a deeper dive into Portfolio Theory and Duration; (iii) what Institutional Life policy-owners can expect in a rising interest rate environment; and (iv) why Institutional Life continues to be a strong, reliable investment.

INSTITUTIONAL LIFE GENERAL ACCOUNT ASSETS

ASSET ALLOCATION

Given the extremely large appetite for life insurance in the United States, insurance carriers are charged with the task of putting huge sums of money to work in the markets, regardless of their own views on the direction of interest rates. Accordingly, insurance companies are one of the largest consumers of high-grade corporate debt, mortgage-backed securities, asset-backed securities, commercial paper and equities. The American Council of Life Insurers (ACLI) estimates that insurance companies own almost 18% of all outstanding corporate bonds. The pie chart below represents a somewhat typical General Account portfolio of carrier holdings.



DURATION OF FIXED INCOME ASSETS

Life insurance companies spend a great deal of time estimating the appropriate asset/liability matching to maximize the overall rate of return and efficiency of the General Account investment portfolio. Institutional Life is designed with long-term holding periods in mind, requiring carriers to invest in like-minded assets. The typical General Account holds predominantly fixed income securities with an overall duration of 8–12 years to support the crediting rates for Institutional Life insurance products.

Credit Unions, which are also large investors in Fixed Income securities, are keenly aware of the volatility associated with long-duration assets in a fluctuating interest environment. Duration is a double-edged sword. While longer durations typically allow for higher yields than shorter duration securities are able to achieve, an increasing rate environment will adversely impact bond prices, which creates near-term capital losses. Regardless of whether the loss is realized or unrealized, the impact on overall investment yields is unavoidable. This is where asset/liability matching becomes critical for carriers, as net cash outflows during a period of rising rates will create realized losses.

PORTFOLIO METHOD

Before diving into the history of Institutional Life crediting rates, a firm understanding of the Portfolio Method is critical to developing a foundation for which Institutional Life rates are based.

Stated simply, the Portfolio Method is when a life insurance company allows cash inflows (premiums) to an established pool of assets (General Account), as opposed to establishing a New Money Portfolio based on current market rates at the time of the cash inflow.

As expected, the Portfolio Method is extremely popular in decreasing interest rate environments. This is due primarily to higher investment yields compared to New Money rates. However, the higher rates are for a limited time until the cash inflows and bond maturities are reinvested at the lower rates, thus decreasing the yield of the portfolio. Conversely, the New Money Method becomes popular when interest rates are increasing and surpass Portfolio rates.

HISTORY AS AN INDICATOR OF FUTURE CREDITING RATES

12-YEAR HISTORY – A DYNAMIC CASE STUDY

The new millennium started with a relative bang in terms of volatility. From the bursting internet bubble to the bursting housing bubble, interest rates started off the 21st century in strong retreat...rebounded shortly thereafter, and finally started the spiral downward yet again. This rate movement provides great insight as to how Institutional Life crediting rates react to the fluctuation in market rates. Figure 1.1 graphically illustrates the asset yield of Treasuries, as compared to the average gross crediting rates for institutional life insurance.

FIGURE 1.1 – HISTORICAL RATE COMPARISON (SINCE 2000)

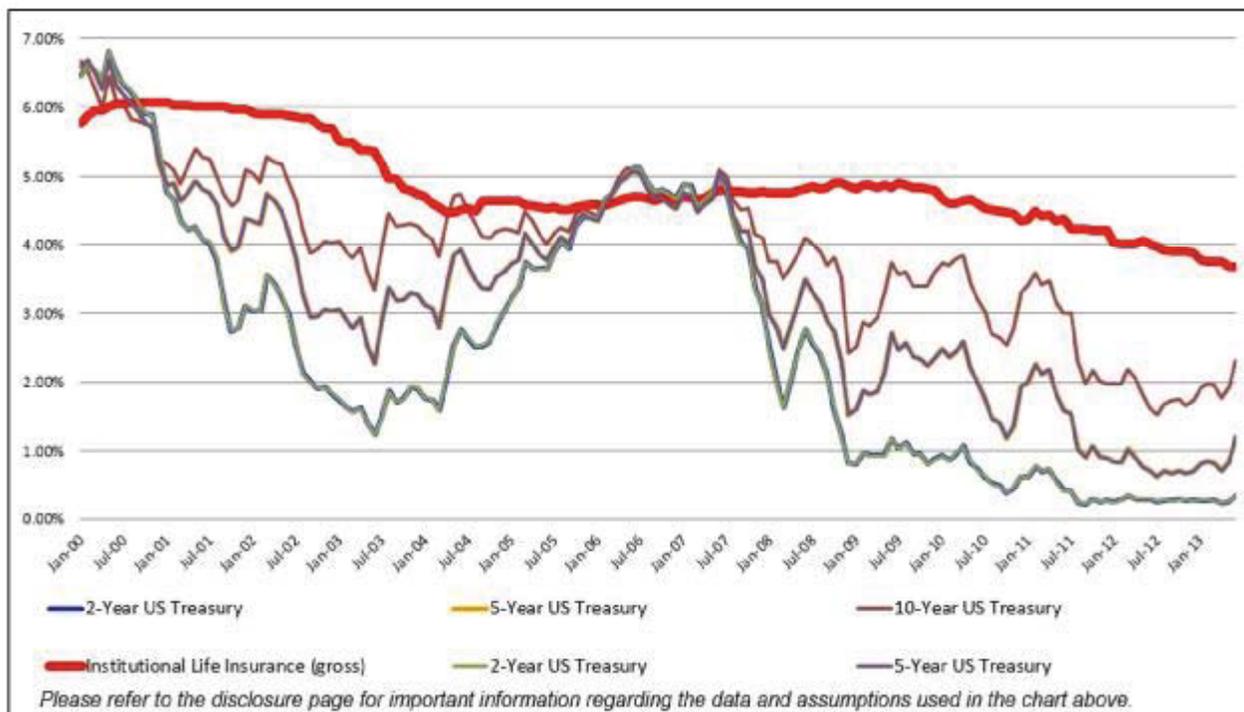


Figure 1.1. Key assumptions:

1. Treasury Rates are considered the “risk-free” rate, but Treasuries for comparison purposes should not imply that Institutional Life insurance is risk-free. The use of Treasuries allows the comparison to be based specifically on the fluctuation of interest rates, and avoids the volatility based on credit spreads (risk).
2. Gross Rates for Institutional Life Insurance – Although gross rates only represent a part of the picture as those rates are calculated before insurance expenses, gross rates still provide a good cross-section of prevailing crediting rates. Net yields can be distorted based on surrender charges, underwriting results, rate locks, and mortality claims.

Since the year 2000, Institutional Life Insurance crediting rates have maintained attractive spreads versus Treasuries, which is not surprising considering the characteristics of portfolio method products. Another point of contrast is the volatility of each asset class shown. While interest rates were quite volatile over this period, Institutional Life Insurance rates followed a slow but steady downward trend, which was a direct result of historically low interest rates for the majority of the time period.

There are three distinctive timeframes to examine more closely, which include increasing, flat and decreasing interest rate environments.

INCREASING INTEREST RATES (JUNE 2003–JUNE 2006)

Despite the moderate volatility of interest rates since 2000, June 2003–June 2006 was the only time period when interest rates trended relatively upward. Treasury rates increased over the period by 316%, 123% and 54% for the 2-Year, 5-Year and 10-Year Notes, respectively. In the same time period, however, Institutional Life Insurance rates decreased by more than 12%. A possible reason for this converse relationship is that a 3-year period is relatively short to provide a material impact on portfolio yields. With the longer duration of life insurance portfolios, a negative correlation in the short-run between life insurance and Treasury rates makes sense. It is

also important to note that although the trend over the 3-year period was increasing, there was also some short-term volatility that took place, as indicated in the table below.

The following table contains data on the 10-Year Treasury versus Institutional Life Insurance for each year of the 3-year cycle:

FIGURE 1.2

	2003–04 (June)		2004–05 (June)		2005–06 (June)		2003–06 (June)	
	10-Year	Institutional Life	10-Year	Institutional Life	10-Year	Institutional Life	10-Year	Institutional Life
Beginning	3.33%	5.36%	4.73%	4.51%	4.00%	4.54%	3.33%	5.36%
Ending	4.73%	4.51%	4.00%	4.54%	5.11%	4.70%	5.11%	4.70%
Change	42.04%	(15.64%)	(15.43%)	0.69%	27.75%	3.50%	53.45%	(12.40%)

FLAT INTEREST RATES (JULY 2006–JULY 2007)

Immediately following the increasing interest rate period of 2003-2006, interest rates remained relatively stable for the next 12 months. Although one year is hardly enough time for life insurance crediting rates to react, especially since they are only adjusted once or twice a year, the time period does provide some useful information. The 10-year Treasury decreased by approximately 2.00%, from 5.09% to 5.00%, whereas, Institutional Life insurance rates increased 2.00%, from 4.71% to 4.80%. Although those percentage changes are small, the opposite direction of the movement provides us insight.

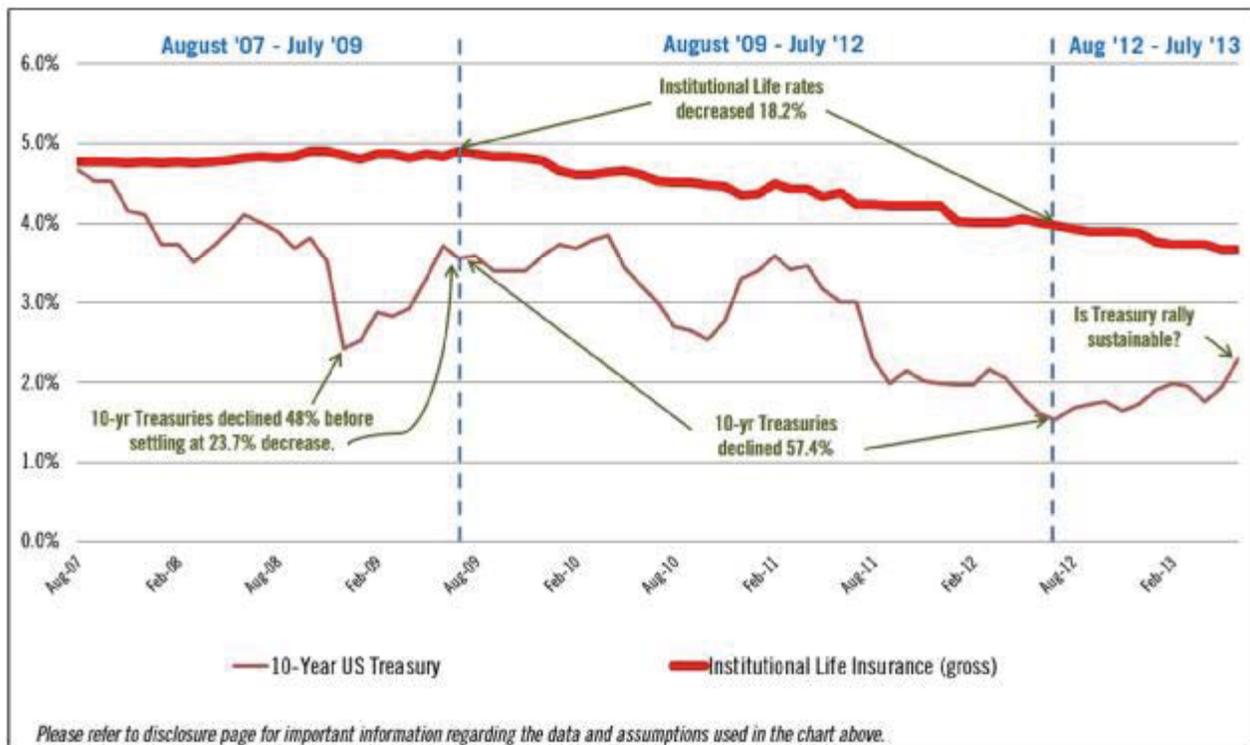
Considering the rising interest rate environment just prior, the slight uptick of portfolio life insurance rates makes sense. In fact, Institutional Life insurance rates not only held their ground, but finally peaked in July 2009 (2 years later) at 4.91%, while market interest rates started plummeting in July 2007 as the “financial crisis” loomed on the horizon. Part of the fuel for this fire would turn out to be the imbedded capital gains experienced by holding large amounts of fixed income assets in a sharply decreasing interest rate environment.

DECREASING INTEREST RATES (AUGUST 2007–?)

The most recent period and likely the most memorable, is the extended period of historically low interest rates experienced over the past several years. This “Great Recession” has resulted in a rapid drop in interest rates fueled by massive stimulus and liquidity measures to revive the U.S. economy. More than five years later, liquidity programs remain firmly in place across the globe as the world economy tries to find solid footing.

The relationship between Institutional Life Insurance rates and Treasuries had its own memorable moments as well. From peak-to-trough for the period, the 2-Year, 5-Year and 10-Year Treasuries fell 95%, 86% and 67%, respectively, while Institutional Life Insurance fell only 25%. High and low points tell only part of the story, so the following table shows the annual breakdown for the 10-Year Treasury versus Institutional Life.

FIGURE 1.3 - HISTORICAL RATE COMPARISON (AUGUST 2007 – PRESENT)



For ease of comparison, 12-month time-frames from August through July are shown. Following are some key observations:

- Aug '07 – '09 (2 years) – Even though Treasuries decreases rather sharply, Institutional Life Insurance rates maintained momentum upwards.
- Aug '09 – '12 (3 years) – Treasuries continued the rapid decline, which finally penetrated Institutional Life rates; however, the rate of decrease was much sharper for Treasuries, where yields fell nearly 60%.
- Aug '12 – '13 (1 year) – Treasuries appeared to pull-out of the downward spiral, but this was deceiving, as a major rally during the last 2 months of the period (June–July) accounted for the entire increase. As would be expected, Institutional Life rates continued in a slow and steady downward trend.

Overall, based upon the assets and duration of the Institutional Life Insurance portfolio, as well as the portfolio method, the data coincides with what one could expect during a 12-year time-frame. Going forward, the ultimate path of market interest rates should dictate the speed of the stabilization and ultimate increase in the Institutional Life Insurance rates.

INSTITUTIONAL LIFE REMAINS AN ATTRACTIVE INVESTMENT FOR CREDIT UNIONS

Based on the recent history of Institutional Life Insurance crediting rates versus Treasuries, the past several years have clearly favored Institutional Life. However, given the dynamics of the Portfolio Method, heavy fixed income allocations and a bias towards longer duration of carrier General Account portfolios, we should expect periods where Institutional Life will underperform relative to Treasuries. As addressed above, we expect any periods of underperformance (i.e., low interest rates causing crediting rates to deteriorate) to be short-lived.

Regardless of what lies ahead, here are some key advantages of Institutional Life as a long-term investment, especially for Credit Unions:

- **Positive Investment Spreads versus Treasuries** – Over the long-term, cash value growth should offer enhanced yields. Although there is a greater degree of credit risk, this is somewhat offset by the strict regulations within the life industry (see “Safety and Soundness” white paper).
- **Interest Rate Risk** – Gross crediting rates are reflective of market interest rates, but changes in bond prices due to changing market rates are absorbed by the life insurance carrier.
- **Correlation to Permissible Investment Portfolios** – After reviewing the information outlined above, allocations to Institutional Life Insurance provide a counter-correlation effect to market interest rates. Credit Unions typically invest a majority of liquidity in Government-backed, short-duration fixed income, and as a result, are exposed to fluctuations in interest rates.
- **Executive Benefits** – The death benefit component provides protection by having the ability to fund long-term liabilities associated with 457(f), Death-Benefit-Only (DBO), Endorsement Split-Dollar or other types of benefits provided to the insured.
- **Cost Recovery** – If held to maturity, Institutional Life Insurance “self-completes” by providing a death benefit payable to the beneficiary (Credit Union).
- **Book Value Treatment** – The stable nature of cash values allows for consistent, predictable returns that are typically held on the Balance Sheet as an “Other Asset” and generate current, non-interest income.

SUMMARY

Institutional Life Insurance ownership for Credit Unions has several benefits, especially when offsetting costs of executive benefits. The prolonged low interest rate environment has impacted Institutional Life Insurance rates, but they continue to provide attractive spreads and other key benefits. With interest rates looking poised to rise, the speed and trajectory of those rising rates may create periods where Institutional Life Insurance rates are not as attractive in the short-run. Permissible investment portfolios will see the benefits from this change right away, and Institutional Insurance will not be far behind.

DISCLOSURES

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- Past performance cannot predict future results. The purpose of this discussion outline is to present the issues and certain mechanics associated with Institutional Life insurance financing strategy. The insurance products shown in this report are representative of the market and are based on a hypothetical investment yield which is not guaranteed.

Important Information Regarding Data, Charts and Tables provided.

The information within the Figure 1.1, 1.2 and Table 1.1 compares the average historical crediting rates in effect for Modified Endowment Contracts ("MECs")--a form of life insurance policy used for financial institution investment purposes--to the historical rates offered for other eligible investment options. The rates indicated have not been adjusted for charges that may apply (i.e., insurance charges, commissions, administrative fees, etc.). The MEC information is averaged from data provided directly by life insurance companies. The US Treasury information is provided from the US Statistical Release website at <http://www.federalreserve.gov/releases/H15/data.htm>.