

Quick Takes

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TIMELY TOPICS FOR INSURANCE EXECUTIVES

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Projected Book Yields for the P&C Industry

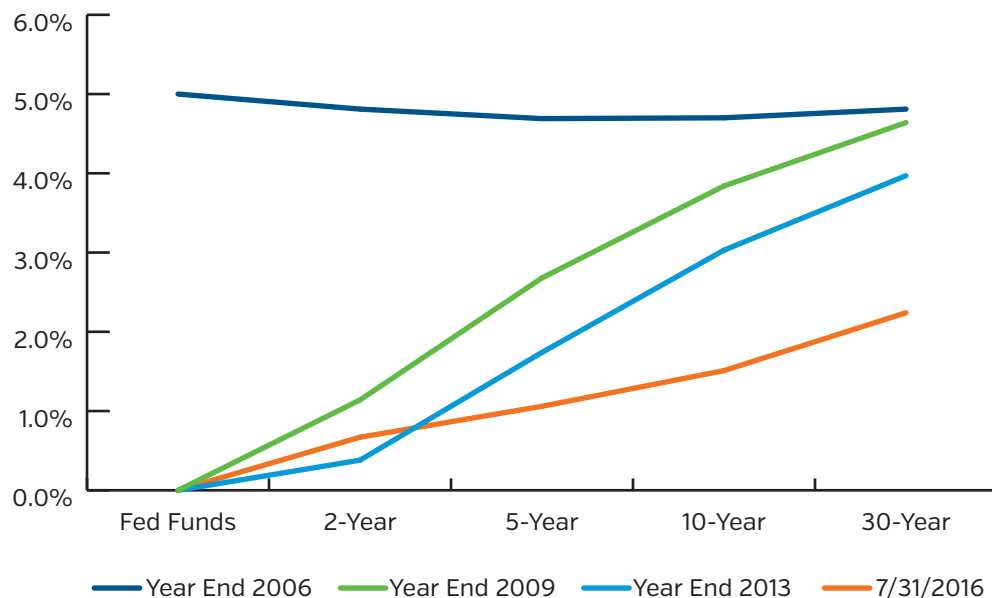
In revisiting our previous analysis of declining P&C industry book yields, we have been interested to observe how closely actual figures have followed forecast. In addition, the future trajectory is more concerning than last year's trajectory, as a flattening of the yield curve in 2016 has created a greater likelihood of continued degradation for years to come. Insurance companies continue to struggle with a low interest rate environment, forcing them to look for creative ways to stem the decline in book yields. The decline in book yield represents a decrease of over 145 bps from 2007–2008. This translates to lost investment income of over \$13 billion¹ for the P&C industry. The significance of the decline is twofold: first, the current low yield environment offers little additional cushion in the face of challenging underwriting conditions; and second, the timeline to restore these yields is being extended, as rates remain lower for longer. In this issue we examine the potential timing and magnitude of the anticipated additional book yield degradation.

CURRENT YIELD ENVIRONMENT

Despite unprecedented monetary stimulus by the U.S. Fed, ECB and other central banks, low growth conditions persist. Interest rates have fallen broadly and remain at historic lows, as shown in Chart 1 [see next page].

Insurance companies are among the constituencies that have suffered the most, with the realization that they will be earning less investment income. While the timing is unclear, higher interest rates would be welcomed by P&C insurers who expect to receive over \$300 billion [over 35% of book value] in principal cash flows by the end of 2018. On the next page we explore the trajectory of future book yields and the important implications it has for the P&C industry's investment income.

Chart 1. Historical Treasury Yield Curves

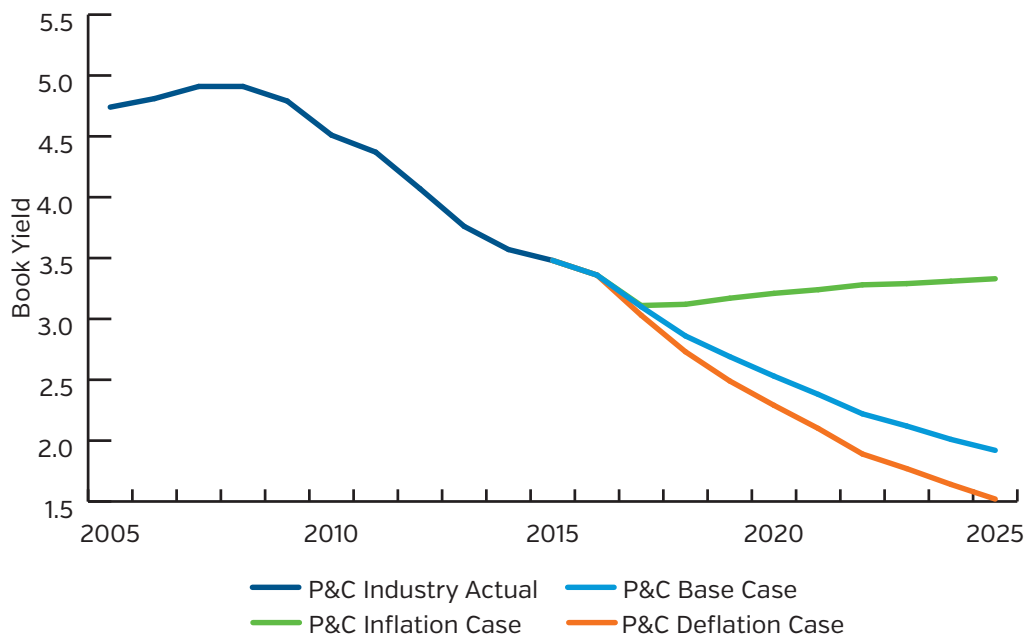


Source: Bloomberg

PROJECTED BOOK YIELDS

Chart 2 shows historical and projected book yields based on 3 potential interest rate paths: a deflation case, base case and inflation case. Table 1 shows the reinvestment rate assumptions used in the forecast scenarios.

Chart 2. P&C Industry – Historical and Forecasted Book Yields



Source: SNL, NEAM

Using our Capital and Risk Analytics (“CARA®”) platform’s cash flow and investment income forecast modules, we have created an income forecast for the entire P&C industry. Last year NEAM forecasted the book yield would be 3.47% at the end of 2015 [excluding cash]. Actual year-end 2015 book yield was 3.44%, very close to our forecast. This represented a decline of 13 bps and more than \$1 billion¹ of investment income in 2015. This year we forecast the industry

book yield will be 3.36% at the end of 2016, a further decrease of 8 bps from year-end 2015. This will result in a further decline of over \$700 million¹ of investment income for the industry. In all of the scenarios presented, the industry book yield does not return to the 3.44% year-end 2015 book yield over the next 10 years. Even in the inflation case, where the reinvestment assumptions are 3.5% in 2018 and 3.75% for 2019 and beyond, it takes more than 10 years for the book yield to recover to year-end 2015 level.

Table 1. Reinvestment Rate Assumptions

	Deflation Case	Base Case	Inflation Case
2016	1.75	1.75	1.75
2017	1.25	1.75	1.75
2018	1.25	1.75	3.50
2018 & Beyond	1.25	1.75	3.75

Source: NEAM

IMPLICATIONS FOR INSURANCE COMPANIES – EXAMPLE

There is a measurable impact of having to reinvest at lower yields which leads to a lower acceptable margin of error for underwriting results. As older, higher yielding securities mature and the resulting cash is reinvested at market rates, investment income per dollar declines. Therefore, all else equal, insurance companies must save more in the future to earn the same investment income they earn today. If we ignore the benefit of future contributions and reinvested income to measure the efficiency of the existing portfolio, we note that forgone future income can be material, absent changes to existing portfolios.

Table 2 shows how the future investment income earnings power of a hypothetical \$100 million portfolio declines as reinvested maturities lead to lower blended book yields. The impact in all scenarios is material at around \$[80,000] in 2016 and cumulative declines over the next 3 years range from \$[270,000] to \$[950,000].

Book yield is an accounting convention that measures a bond's recurring realized investment income that combines both the bond's coupon return plus its amortization. Generally it is yield-to-worst at the time of purchase. Book yield is reported as effective rate of interest on Schedule D and is a factor in calculating and forecasting investment income.

Table 2. Implication Example

	Deflation Case	Base Case	Inflation Case
Starting Book Yield	3.44%	3.44%	3.44%
2016	3.36%	3.36%	3.36%
2017	3.03%	3.10%	3.11%
2018	2.73%	2.86%	3.12%
2019	2.49%	2.69%	3.17%
Incremental Change to Book Yield			
2016	-0.08%	-0.08%	-0.08%
2017	-0.33%	-0.26%	-0.25%
2018	-0.30%	-0.24%	0.01%
2019	-0.24%	-0.17%	0.05%
Cumulative Change to Investment Income per \$100 Million of Book Value*			
2016	\$(80,000)	\$(80,000)	\$(80,000)
2017	\$(410,000)	\$(340,000)	\$(330,000)
2018	\$(710,000)	\$(580,000)	\$(320,000)
2019	\$(950,000)	\$(750,000)	\$(270,000)

Source: SNL, NEAM

* Assumes no reinvestment of interest income and no operational contributions or withdrawals.

STRATEGIES TO MITIGATE BOOK YIELD DEGRADATION

In this interest rate environment, preserving and/or increasing book yields is paramount. Evaluating changes to investment strategies should be viewed within the context of overall enterprise risk tolerance as well as rating agency [BCAR] and regulatory constraints. Based on the analysis of the interrelationships between insurance company business lines and current investment opportunities, there may be opportunities for insurance companies to reconfigure portfolios to improve book yield profile without increasing enterprise risk.

KEY TAKEAWAYS

- Book Yields may not have hit bottom and may not return to the 12/31/2015 level for years to come
- Net investment income declines in the base case scenario until at least 2025, absent portfolio changes
- Opportunities to reconfigure portfolios to improve investment income should be considered within the context of an enterprise risk management framework
- NEAM's CARA® Platform can assess and forecast Insurance companies investment income and book yields

ENDNOTE

¹ Figure represents annualized forgone investment income based on 12/31/15 P&C industry book value of \$893 billion.

NEAM's portfolio management tools have been utilized to provide the projected book yields based on certain assumptions. These assumptions include the reinvestment rates. These projected book yields do not take into consideration the effect of taxes, changing risk profiles, operating cash flows or future investment decisions. Projected book yields may not reflect the effect of material economic and market factors. Readers may experience different results from any projected book yields shown. Results shown are not a guarantee of future book yields. Please carefully review all of the information presented by NEAM.



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