



M Financial Group™

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M Intelligence

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The Impact of Recent Interest Rate Increases on Universal Life Crediting Rates and Whole Life Dividend Interest Rates

Over the past 25+ years, universal life (UL) crediting rates and whole life (WL) dividend interest rates (DIR) have been declining due to lower insurance company portfolio yields in a declining interest rate environment. With the rise in interest rates (e.g., treasuries and corporate bonds) at the end of 2016, many are wondering if the end of declining UL crediting rates and WL DIRs is near.

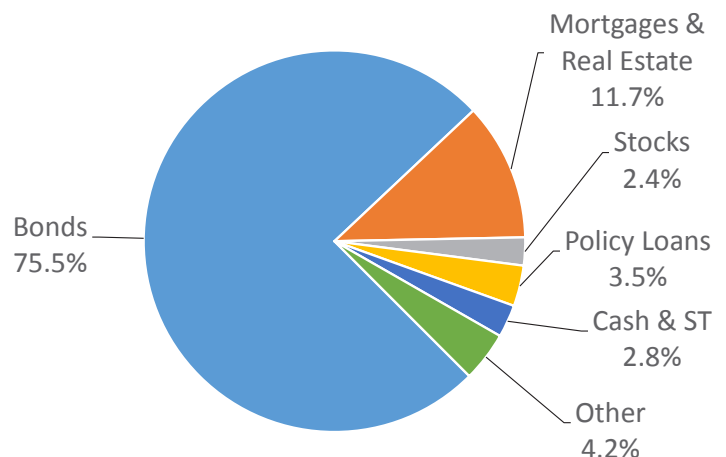
This M Intelligence piece is designed to offer insight on this question by examining the fundamentals that drive UL crediting rate and WL DIR movements and establish expectations going forward.

Insurance Company Portfolio Yields Lag New Money Rates

UL crediting rates and WL DIRs are supported by insurance company portfolio yields. Insurance companies change crediting rates and DIRs (subject to the guaranteed minimum rates) as the portfolio yield varies. For example, if the portfolio yield declines by 25 basis points (0.25%) then the UL crediting rate or WL DIR may also be reduced by approximately 25 basis points and vice versa.

See Figure 1. More than 85% of insurance carrier asset portfolios consist of investment-grade bonds and mortgages.

Figure 1: Life Insurer General Account Investments 2015



Source: A.M. Best Statement File

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Interest rates have been generally declining for the past 30+ years, putting downward pressure on portfolio yields and leading insurance carriers to lower crediting rates and DIRs in order to maintain pricing interest margins.

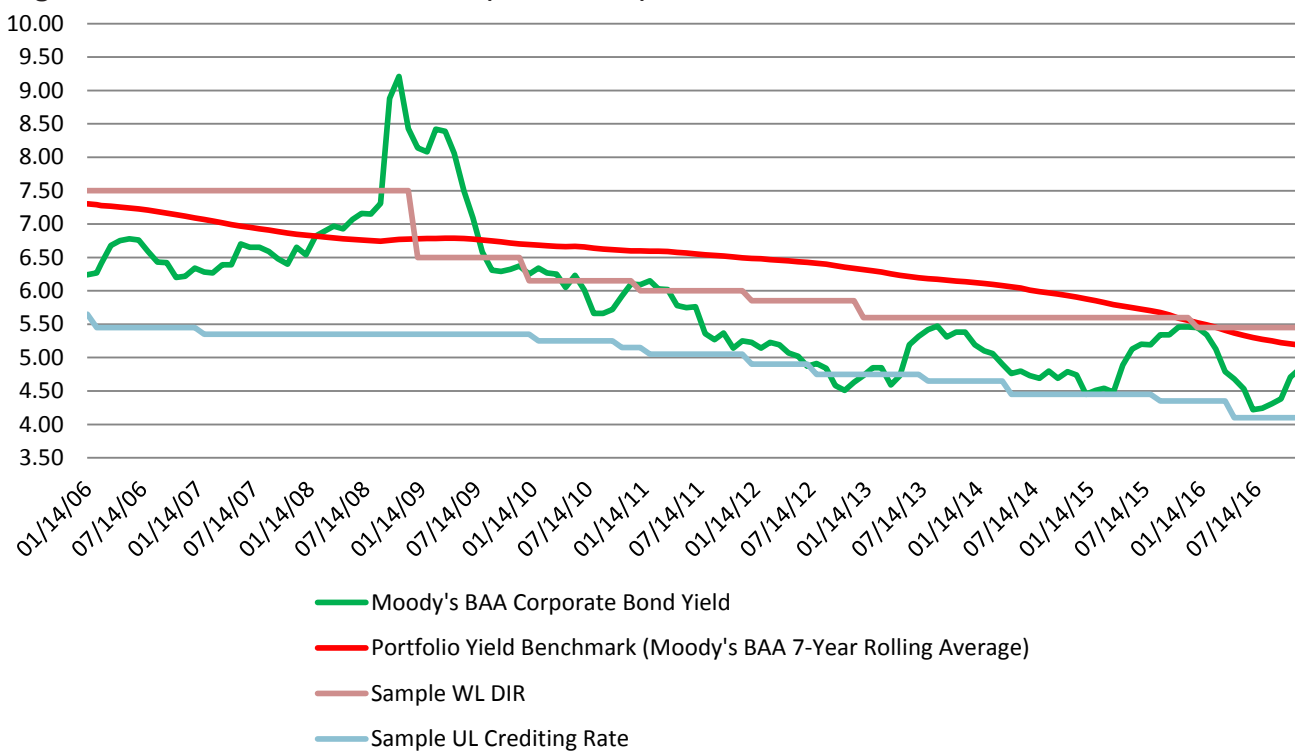
See Figure 2. The Moody's Baa Corporate Bond Yield, a new money rate, represents a typical insurance company investment and the 7-year rolling average represents a proxy insurance carrier portfolio yield with assets turning over with time. The decline in interest rates and portfolio yields has been dramatic—interest rates were approximately 9% as recently as 2009; today they are below 5%, even with the recent rise in rates (interest rates were even higher, in the 12–13% range, in the early 1980s). The rolling average rate (i.e., proxy insurance

company portfolio yield) chases the new money rate (i.e., corporate bond rate) and there is a strong correlation with the sample UL crediting rate and WL DIR movements.

WL DIRs are typically larger than UL crediting rates. But unlike crediting rates, DIRs are not the actual interest rate credited to the policy value. DIR movements, however, tend to follow movements in portfolio yields. Refer to the appendix for further explanation.

As shown in Figure 2, even with the recent rise in new money interest rates, new money rates remain below portfolio yields (by approximately 50 basis points). Therefore, there is continued downward pressure on portfolio yields, UL crediting rates, and WL DIRs.

Figure 2: Historical Interest Rates (2006–2016)



Source: M Financial Group

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UL and WL Rate Projection

An estimated projection of changes to insurance carrier portfolio yields can be calculated by using a proxy portfolio yield benchmark like the 7-year rolling average of Moody's Baa Corporate Bond Yield. This benchmark reflects the turnover of assets over time, and the slightly lower quality and longer duration assets, insurance carriers have recently trended towards in an effort to capture additional yield.

The projected portfolio yield benchmark depends on an assumption for the direction in future new money rates (i.e., Moody's Baa).

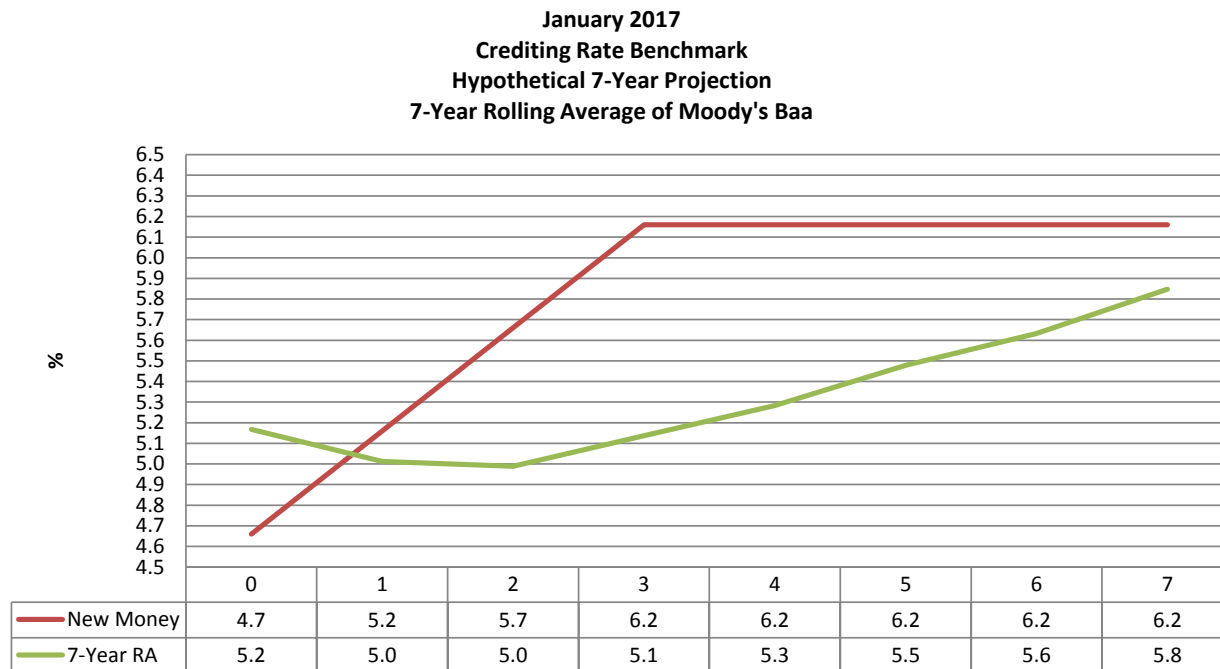
Many economists believe that interest rates will continue to rise, albeit slowly and with ups and downs. A Standard & Poor's (S&P) economic research paper published on

December 1, 2016 (*2017 U.S. Economic Forecast: Stir It Up... Will Trump Boost Growth?*), includes a baseline forecast that the Moody's Corporate Bond Yield will increase approximately 50 basis points (bps) annually over the next two years.

Drawing upon the S&P forecast for the projection, we will assume a similar scenario where new money corporate bond rates increase 50 bps per year over the next three years and then stay level.

See Figure 3. This projection shows that portfolio yields will continue to decline for the next two years before rebounding and will not exceed today's level until four years out.

Figure 3: Insurance Carrier Hypothetical Portfolio Yield Benchmark Projection



Source: M Financial Group

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Conclusion

Monitoring interest rate increases, patience, and managing client expectations are critical in this environment. It is unlikely the recent rise in interest rates will have an immediate positive impact on UL crediting rates and WL DIRs.

While the recent increase in interest rates is welcome news and could eventually drive higher portfolio yields and UL crediting rates/WL DIRs, the main takeaway is this: portfolio yields will most likely continue to decline over the short term (one to two years) as portfolio yields lag new money rates and new money rates continue to be below portfolio yields (approximately 50 bps as of today).

Due Care practices for policy management and evaluation remain essential to meeting policyholder financial goals:

- Conduct ongoing policy reviews to assess actions to maintain financial goals
- Stress test policies with lower rates to better understand risk
- Fund insurance policies conservatively to provide cushion for lower crediting rates
- Explore other product types that may provide flexibility and diversification with a potential enhanced yield (VUL or IUL with multiple options for premium allocation between general account, index account, or separate account)
- Consider products that provide guarantees such as no-lapse guarantee UL

The current environment also underscores the importance of working with an experienced life insurance practitioner who understands product dynamics and provides ongoing policy reviews.

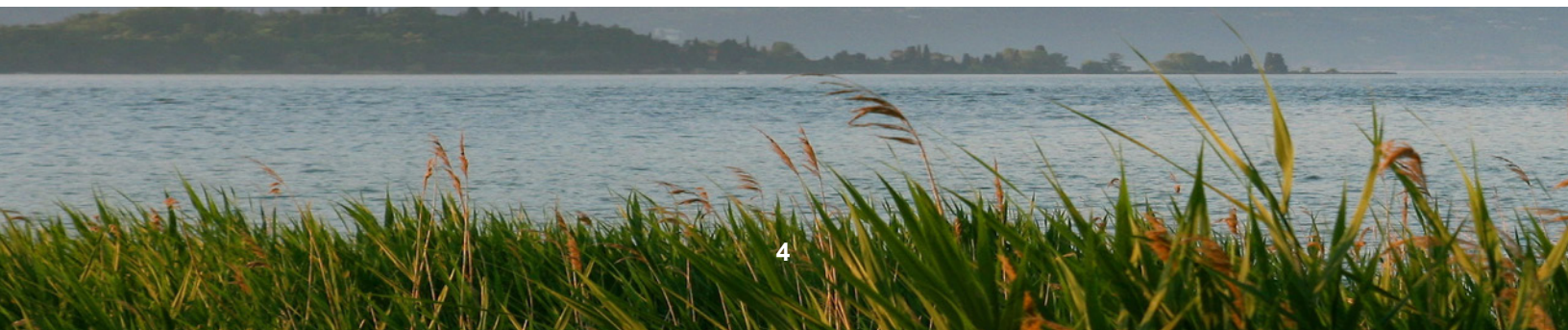
Appendix—WL DIR Explanation

The declared dividend interest rate in a participating WL policy has a very different application than a UL crediting rate. Therefore, dividend interest rates are not comparable on an absolute basis.

To illustrate this point, in most participating WL policies, one part of the dividend is based on a formula using the declared dividend interest rate. The formula can be generally described as taking the excess of the declared dividend interest rate over the policy guaranteed rate multiplied by the “policy value.”

While this formula is straightforward, its application varies widely by insurer and policy. By example, some insurers may make additional deductions from the declared DIR to cover expenses or mortality and some policies will have multiple guaranteed interest rates to choose from (e.g., one for policy cash surrender value and one for policy reserves). There is also wide variation in what is used in “policy value” which may be a reserve, a cash surrender value, the greater of the two, a year-end value, or a mid-year value, etc.

For these reasons, it is difficult to draw reliable conclusions from comparing the absolute DIRs of various policies. In fact, many insurers who issue participating WL policies have stopped publishing a DIR because the rate can mean different things to different people, and reliance upon the absolute rate can be misleading. However, because changes in DIRs over time have tended to align with new money interest rate movements, this analysis does provide helpful perspective for policyholders.



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