

The Insurance *perspective*

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Economic Commentary



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Although the exceptional equity market rally observed in the S&P 500 continued to shine in the 1st quarter of 2021, it was overshadowed by the rise in yields on longer dated Treasury securities. Specifically, since year end 2020 the yield on the 10-year and 30-year Treasury rose an astonishing 82 and 76 bps, respectively. Even though a 1.74% yield on the 10-year is still low by historical perspectives, the quick rise in yields that took place in Q1 2021 showed just how delicate the financial system is to its inputs.

US Bond Market- There were many reasons to be a seller of US Treasuries in the first quarter of 2021. For instance, positive vaccine effectiveness and distribution continued to spur hope of a continued economic recovery. The supply of Treasury securities was

increased during the quarter by the \$1.9 trillion stimulus bill and there are expectations of additional supply from the roughly \$2 trillion infrastructure bill currently in the works. The fiscal spending plans and continued economic recovery added to the rising inflation expectations, and finally pushed inflation expectations to the 2% mark that is coveted by the FOMC. With a 2% inflation finally in the runway, holding onto Treasuries that pay less than the inflation rate nets holders a negative real yield, leading to selling pressure of Treasuries. Just as the Coronavirus pandemic caused the yield on the 10-year Treasury to tumble below 1%, a small change in inflation expectations caused it to soar back above 1.5%. The 1st quarter of 2021 showed us just how interconnected the capital markets are, as this rise in yields echoed across the equity markets.

US Stock Market- The equity market was getting comfortable with the concept of low rates forever just to have this sudden rise in Treasury yields in the 1st quarter of 2021. The movement of Treasuries reverberated across the market in different ways as the Dow Jones, S&P 500, Nasdaq, and Russell 2000 indexes returned 8.29%, 6.17%, 2.96% and 12.69% during the 1st quarter respectively. As markets adjusted to the reality that longer dated yields can rise, this led to higher discount rates being factored into valuations, disproportionately affecting tech stocks more than dividend paying Dow Jones stocks. This created a continued rotation to value during the 1st quarter.

The market rally has created concern that we are in a bubble with the higher P/E ratio of the S&P 500 being cited as a cause for concern. However, whenever you invert the P/E ratio to get the earnings yield, it is currently at 4.35%. When this earnings yield is compared to the yield of the 10-year Treasury, 1.74%, the premium for holding equity over the 10-year Treasury is about 2.61%. This positive premium is lower than the average premium since 2008, however, it is significantly better than the negative premium observed during the dot-com bubble. Even though Treasury yields rose substantially in the 1st quarter, the improved economic outlook led to higher EPS expectations and the equity risk premium was relatively unchanged from year end, when rates were much lower. So, although the market is grappling with higher rates, it is also reconciling with higher earnings expectations. Maybe the concern shouldn't be on current overvaluation, but it should be that higher inflation will raise rates faster than earnings recover.

FOMC- The statements at the March FOMC meeting repeated what they have been saying since the beginning of the pandemic. They plan to keep rates low through 2023, they are willing to use every tool possible to maintain stable markets, the Fed will let us know well in advance before they start to taper any Treasury purchases, and they want inflation to average 2% with maximum employment. Even with the FOMC repeating their goals, the biggest question mark comes from the ambiguity of the 2% inflation and maximum employment goal. We know that the FOMC wants inflation to average 2%, but over what time frame, and to what extent is inflation allowed to rise to reach a 2% average? Additionally, what is the directive if we have 2% average inflation but high levels of unemployment, or full employment but low inflation? Would either of these scenarios make the FOMC look to raise interest rates?

While commodity prices continue to rise from both supply and demand issues, it is uncertain whether the 1970's era inflation will reappear. The large fiscal spending and fiscal deficits being created by the US government are a concerning historical sign. However, a rise in inflation or increasing deficits may be short term in nature, and may be softened by the fact that other central banks are following suit with similar fiscal policies. Additionally, increasing consumer saving habits could prevent the inflation from occurring. The all-time high "Cash at Banks" figure has been seen as dry powder waiting to explode in the economy, but the COVID-19 pandemic illuminated the importance of maintaining a strong cash balance for both companies and individuals. Additionally, there could be hinderances to spending with travel being limited due to the virus and the large unemployment in the US, and maybe the powder stays dry or is used in manageable intervals.

Summary- Maybe the market is priced to a T. Earnings may be discounted at the proper rates, rates may have risen by an adequate amount with the additional stimulus, the expected growth in GDP and the expected inflation just might be perfectly aligned. Maybe, during the 1st quarter, we witnessed the tightrope artist successfully take another step in the direction of recovery. As long as the variables that drive the market move in lockstep, the balancing act can continue. Just like the tightrope artist, I expect the market will assure that it has firm footing before taking its next step forward, but if things move too quickly from here, the risk of failure increases.

Industry Insight

ERM and Investment Risk Mitigation Strategies for Insurers



Theron R. Holladay, Sr., CFA
President & CEO

Managing risk is a fundamental focus for insurance companies. Enterprise Risk Management or ERM is a trending topic within the industry. Large companies are required to conduct an ORSA, ERM is a key focus of rating agencies and many states are considering additional requirements for smaller organizations. ERM discussions can seem overwhelming; however, at its core, ERM is simply the process in which an insurer identifies risk and develops mitigation strategies around key risks. A fundamental aspect of ERM is that it must be specific to each insurer and should permeate through every area of the company. A key risk for one insurance company might be a low risk for an organization with a different history, product or asset mix. This acknowledged, there are certain risks that impact all insurers and some mitigation strategies are expected or even required by regulation. These include:

cyber security policies, disaster recovery plans, certain governance provisions, reserving requirements and the investment plan. The investment plan is by design a document intended to mitigate risk for an insurer. It was an ERM policy in use long before the term ERM was being discussed. In the remainder of this article, I will address two risk mitigation strategies that all insurance companies should consider as part of the investment plan.

Regulation surrounding the invested assets of an insurer is very specific. Statutory accounting, NAIC regulations and state laws on permissible investments are designed to limit risk and focus investment decisions around the products that are sold by the insurer. By design, statutory accounting and regulation focuses insurance performance around net investment income and positive impacts to capital and surplus. Ultimately, an insurer is focused on producing the highest possible net investment income considering the risk constraints that are specific to the company. The investment plan of an insurance company should address both the risk and return objectives. It should contain any risk mitigation strategies specific to the organization and any items required by the State Insurance Department.

While there are many risks that can impact the investment of an insurer, the nature of an insurer places primary importance on two key risk factors. The investment plan should contain a mitigation strategy designed to reduce risk in each of these areas:

- 1) Providing that the assets are invested in the most efficient manner in order to provide for the specific liabilities of the company (ALM policy) and
- 2) Providing for proper asset diversification considering the specific company's financials and the total adjusted capital.

ALM Policy

The most efficient method for considering the assets in relation to the liabilities is very specific to the individual characteristics of each insurer. The type of products offered by the insurer is the main factor that determines the appropriate portfolio maturity and cash flows. The purchase of a ten-year bond could be a high risk for one insurer while significantly reducing the risk of another. This feature is centered on the basic obligation that there are sufficient cash flows to provide for the policyholders. This is the nature of State and NAIC regulations including the nature of book value

accounting and reserves such as IMR/AVR. An effective ALM strategy will reduce total insurance risk by minimizing both market and reinvestment risk. For life insurers, an effective strategy will almost always consist of structuring asset cash flows that provide for the projected future liability cash flows. A portfolio with asset cash flows that match the liability cash flows in every projected future year is referred to as an immunized portfolio. Standard life products typically have longer duration and tend to have less volatility in changing interest rates. This makes a more direct immunization policy more applicable. Annuity products have more volatility in changing interest rates and the cash flows of these products often moves inversely to changes in asset cash flows. The key is understanding how both the assets and liabilities shift in changing interest rates and requires that the investment team works closely with the actuary. A P&C insurer does not have the mathematical liability cash flow structure of a life company; however, this does not remove the need for a policy. There is often a need for the creation of a constant stream of cash flows within the portfolio that reduces risk in various economic cycles. An effective strategy must also include understanding expected future cash flows, the amount of reinsurance, product rates and seasonality patterns to claims. Without an effective strategy an insurance company can inadvertently create a scenario that increases risk and produces future surplus drift. An ALM policy will look different for every insurer, but is key to financial success and the one risk that most directly relates to the return that is most appropriate.

Diversification Policy

Diversification is just as important; however, it is often applied inappropriately to insurance portfolios. Diversification objectives should be at the core of any well-developed insurance investment plan. Most people understand the importance of not having all of your eggs in one basket and diversification is discussed by most investment managers and investment programs. What is sometimes overlooked is that diversification parameters are very different for insurance companies when compared to other types of investors that consider diversification in terms of overall assets. Insurance companies that consider the typical areas of diversification can be unintentionally hurt by investment decisions.

Diversification for an insurance company should consider the size of any investment as it relates to the capital and surplus of the firm and the amount of any Asset Valuation Reserve, for life companies. Targets should be set that would allow for several security issues before capital is reduced. Allocations to any single issuer should be limited to a range of 1 – 20% of capital and surplus or unassigned funds. This range allows for government securities at the upper level and other investment grade issues at the lower levels. For insurers with AVR, the investment in any single security should be limited to the point that the company's standard AVR could absorb several issues or surprises before any impact to capital occurs. It is still important to consider diversification across all categories in assessing the risk of any investment portfolio. This includes diversification by asset type, geographic location, industry, collateral type, coupon, maturity, and placement into the market. Regardless, the main factor that protects insurers is diversification in relation to capital and surplus. This is why a Diversification Policy is fundamental to the investment plan.

Another RMBS/CMBS Ratings Dilemma



Jamin Phillips,
Investment Accountant

An ongoing conversation between insurance companies, the NAIC, and various working groups, specifically the Structured Securities Group, has been happening since the Financial Crisis of 2007 and into the subsequent years. To say the crisis was created by over issuance of mortgages and lack of transparency in the securitization of those loans has been discussed ad nauseum. In the attempt to protect insurance companies, many steps were taken to appropriately assign ratings and apportion an appropriate amount to RBC and AVR (for life insurers). In 2009 the NAIC introduced a breakpoint approach for RMBS and CMBS securities. In summary, the NAIC rating was determined by the

book/amortized price of the security. The security, the intrinsic price, and Book Values were evaluated by a price grid to determine what the rating designation would be. The breakpoint method benefited the insurance industry and the economy as a whole to protect insurance companies from substantial and possibly devastating risks while giving more opportunity for more mortgage-backed securities to be bought and sold in the market, which in turn created opportunities for homebuyers and property investors to build equity. For example, some insurance companies were able to buy MBSs at 50 to 60 cents on the dollar. At such a great discount, the risk of these investments were minimal. As the economy recovered, RMBS and CMBS securities began to trade near or above Par again and interest rates continued to fall. The NAIC introduced a “No Loss” exception to the models. A “No Loss” security could be designated a “1” if it had a “zero loss” in any of the modeled scenarios presented and would be rated from AAA to A under Filing Exempt rules, regardless of the book value.

The breakpoint methodology has its flaws though. Another financial crisis brought these flaws to the surface quickly. In the early Spring of 2020, interest rates were tanking and there were many uncertainties of the equity markets because of the COVID-19 Pandemic and everything that followed. Because of the low rates, many of the highly rated, conservative, and upper tranche CMBS and RMBS were traded at premiums. Under this scenario, it would take longer to get to the breakeven point as a “zero loss” security, especially for a fixed rate MBS. Risks began to get even worse from here. For some securities that were considered AA to A, the “No Loss” could no longer be applied partly because of the modifier letters that now follow the Rating on Schedule D. This had significant unintended consequences. The price breakpoint calculations were creating what should have been anomalies according to the models due to high premiums on high quality securities. Mortgage-backed securities with high credit ratings backed by sound loans were beginning to report as NAIC 2, 3, or even in some cases 4. (See figure 1 for the damage that this can have on an insurance company.)

(RBS/CMBS cont'd)

Figure 1

RBC charge / NAIC designation (pre-tax)		
P&C	RBC	Midpoint
1	0.3%	0.65%
2	1.0%	1.50%
3	2.0%	3.25%
4	4.5%	7.25%
5	10.0%	20.00%
6	30.0%	
Life	RBC	Midpoint
1	0.4%	0.85%
2	1.3%	2.95%
3	4.6%	7.30%
4	10.0%	16.50%
5	23.0%	26.50%
6	30.0%	

As you can see, the RBC charges for an NAIC 4 compared to an NAIC 1 rated security are significant. To put into perspective how it could affect the entire industry, the NAIC reported that as of year-end 2019, insurers held \$8 Billion of CMBS which had original ratings of AA or A, were “zero loss”, and held at an average price of \$101.1. Considering the impact of the events of early 2020, low interest rates, and uncertainty in the equity markets, the allocation to highly rated mortgage products went up as well as the average cost. Even considering those factors, these should have been considered low-risk. Thankfully, many insurers and the NAIC noticed this before the end of 2020 and were able to offer a temporary fix to this issue.

The Price Grid model is a good model overall, but it does create problems for more expensive, low risk, sound investments that need to be financially modeled. This model will continue to be used for “Legacy Security RMBS and CMBS.” A “Legacy” is defined as a MBS that was issued before January 1, 2013. This makes sense because most structured mortgage-backed products issued before that date should be either paid down or amortized down enough to know what risk of loss is remaining. This date is also appropriate because, generally speaking, the life cycle in real estate lasts about eight years. These securities will be “grandfathered” in by using this financial model for ratings. They will also continue to use the “FMR” or “FMC” symbols if necessary.

(RBS/CMBS cont'd)

Securities issued on or after January 1, 2013 will be modeled by a more appropriate method. These are referred to as “non-Legacy Security RMBS and CMBS” or “non- Legacy”. The Structured Securities Group of the NAIC created a temporary fix to the 2020 schedules to protect the RBC and AVR (for life companies) from being penalized. The NAIC suggested lowering the “zero loss” threshold to 99.15 and to eliminate the price breakpoints entirely. Other recommendations are to move to a single NAIC designation and category. The midpoint of each designation would be used. For example, a 1 would be a 1.D, a 2 would be a 2.B, 3, 4 and 5 would all be followed by a “B”, and a 6 would not have a modifier. For the meantime, this will not affect the RBC because each number designation has its own factor. This could change in the future. Another change is to introduce a NAIC Designation Intrinsic Price Mapping. The Intrinsic Price is defined as 1 minus the weighted average of discount principal losses expressed as a percentage, reflecting the credit risk of the security. This could be mapped to the midpoints between each adjoining RBC charges. (See figure 2.) These would not be affected by the book price, or the premium paid, but by the underlying properties that make up the security.

Figure 2

<u>NAIC Designation Determined by Modeled Price Ranges</u>	<u>Mapped NAIC Designation Category</u>
1	1.D
2	2.B
3	3.B
4	4.B
5	5.B
6	6

My hope is that there is a permanent solution to this issue for year-end 2021 and insurance companies will not have to worry about unloading very good securities to mitigate their risks when there isn't much. I am also confident this method of rating will be more transparent than the pricing grid method.

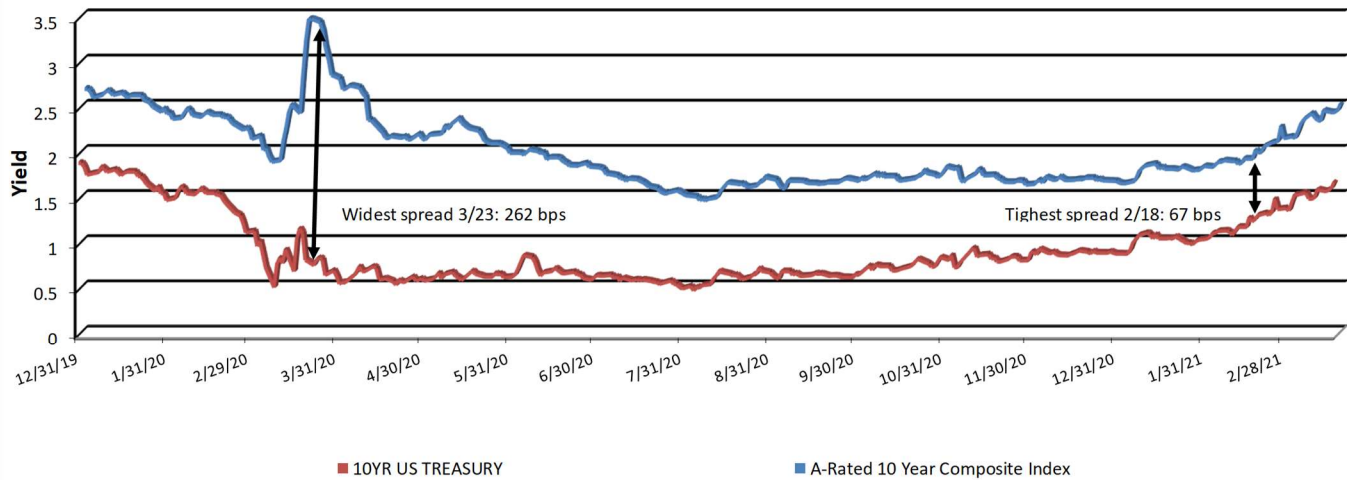
Interest Rate Spreads

As of: 3/31/2021

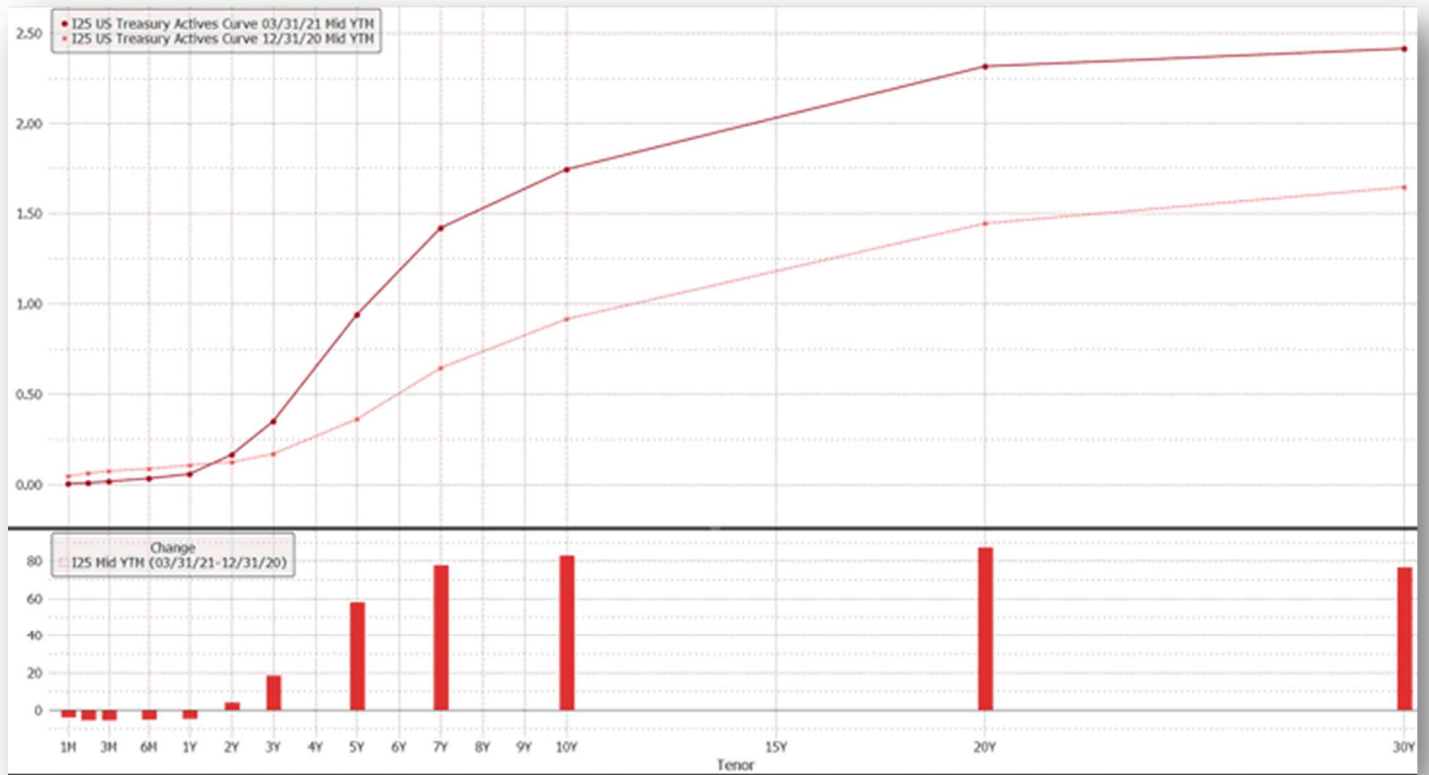
Term	Treasury Yield	US Composite BVAL AA Curve		US Composite BVAL A Curve		US Composite BVAL BBB Curve		US Composite BVAL BB Curve	
		Yield	Spread	Yield	Spread	Yield	Spread	Yield	Spread
1yr	0.07	0.226	0.156	0.276	0.206	0.508	0.438	1.679	1.609
2yr	0.16	0.314	0.154	0.407	0.247	0.67	0.51	2.117	1.957
3yr	0.35	0.538	0.188	0.663	0.313	0.934	0.584	2.559	2.209
5yr	0.92	1.185	0.265	1.329	0.409	1.616	0.696	3.344	2.424
7yr	1.4	1.739	0.339	1.907	0.507	2.235	0.835	3.964	2.564
10yr	1.74	2.285	0.545	2.472	0.732	2.832	1.092	4.53	2.79
20yr	2.31	2.993	0.683	3.231	0.921	3.677	1.367	5.488	3.178
30yr	2.41	3.18	0.77	3.324	0.914	3.624	1.214	5.27	2.86

Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Bloomberg and represents the respective Bloomberg US Composite BVAL and Bloomberg Fair Value Composite Curves. Spreads are calculated off the Treasury yield for each term.

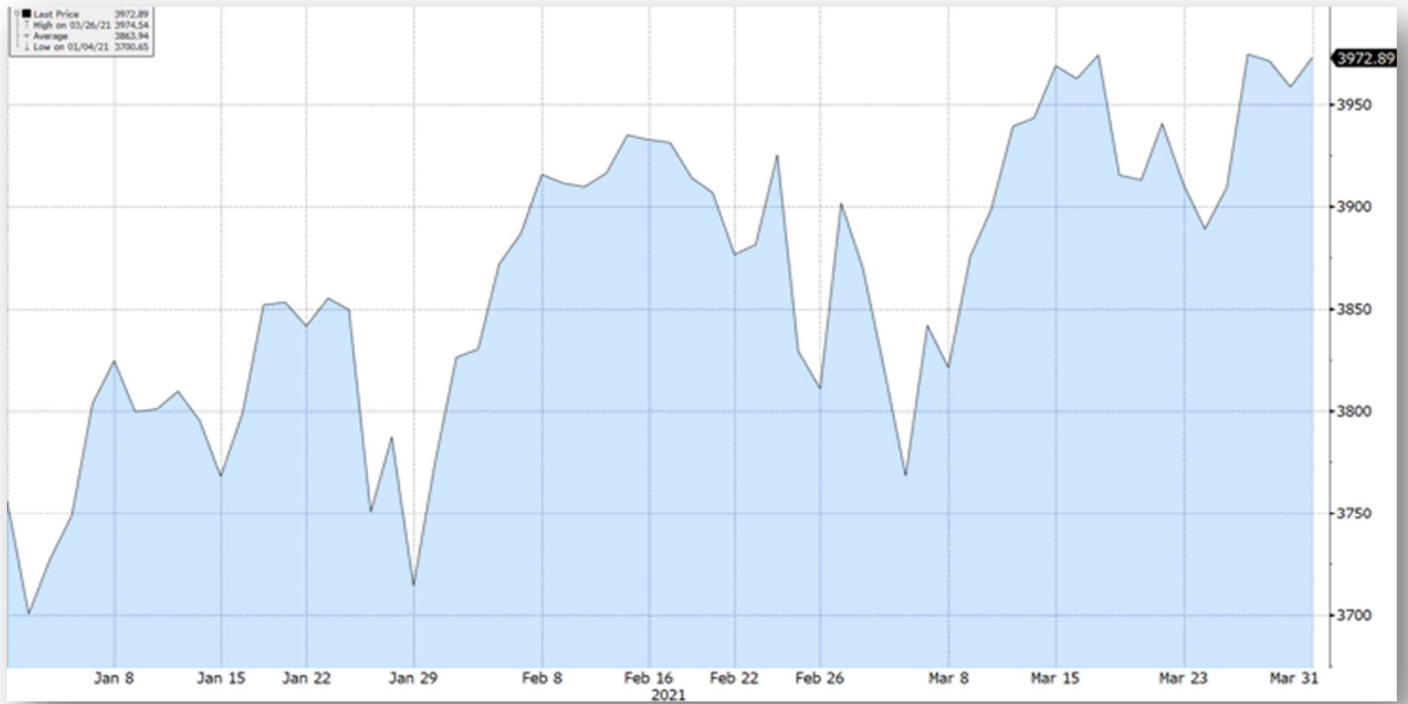
10yr Yield & Spread



US Treasury Yield Curve



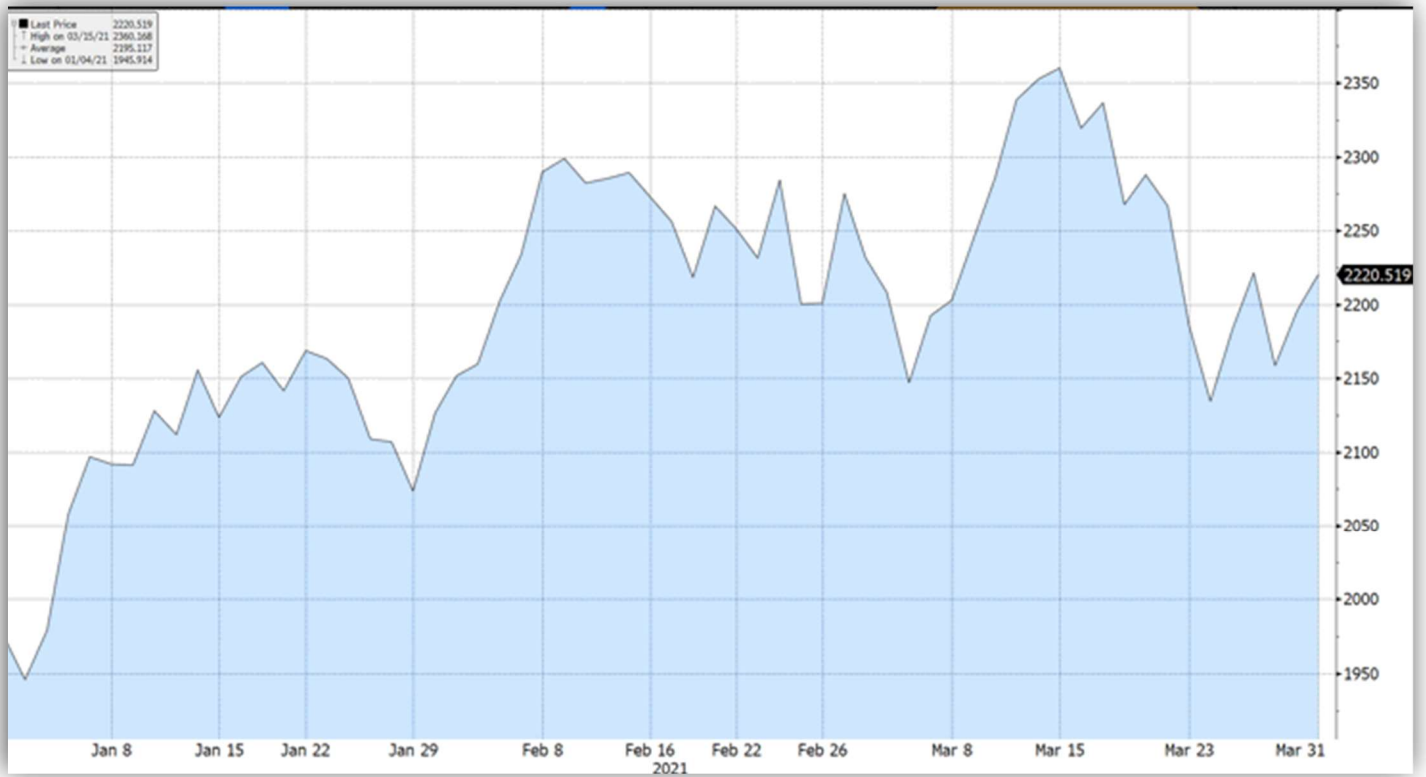
S&P 500 Index



Dow Jones Industrial Average



Russell 2000 Index



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The Insurance Perspective is a quarterly publication prepared by the staff of Parkway Advisors, L.P. Each issue focuses on the U.S. economy and specific insurance industry issues and/or concepts. Our clients and prospective clients enjoy Parkway's dedication and unique focus on the insurance industry.

For More Information

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