

# *The* Insurance *perspective*

2023- Volume 26



**PARKWAY**ADVISORS

6550 Directors Parkway

Abilene, TX 79606

800.692.5123

[www.parkwayadvisors.com/](http://www.parkwayadvisors.com/)

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# Economic Commentary



**Bryce Bevill**  
Investment Associate

Investors have become very familiar with volatility over the last several quarters, which continued through the fourth quarter of 2022. Although markets remain volatile, CPI began a downward trend in the quarter, ending at 7.1% down from a high of 9.1% in June. This eased some investor concerns and resulted in a slight market increase in the quarter. As expected, The Fed continued to tighten monetary policy, however, at a slower rate due to the reduction in year-over-year CPI increases.

**Federal Reserve** - When the Federal Reserve met in November, the Fed made its fourth consecutive increase of 75 basis points, resulting in the target range increasing to 3.75% - 4.00%. Following this increase, Fed Chairman Jay Powell signaled that the committee is committed to continued rate hikes although the size of increase would begin to decrease. That signal remained accurate following the Fed meeting in December, where The Fed Fund rate was increased by a slightly lower, 50 basis points. The Federal Funds target rate ended the year considerably higher than it began, at a range of 4.25% - 4.50%, up from 0.00% - 0.25% in January. As of the December meeting, The Fed's dot plot reflects the current consensus that rates will climb into the 5.25% - 5.50% range in 2023 and 4.25% - 5.00% in 2024. However, the market is currently pricing in a lower terminal rate of 4.75% - 5.00% for 2023. The committee stated that it remains strongly committed to returning inflation back to its 2 percent mark, meaning that the aggressive monetary policy in place is projected to continue.

**Domestic Fixed Income Market** - Throughout the fourth quarter, yields on the 10 year treasury stepped up approximately 40 basis points to its highest level in October. However, yields then fell in November resulting in the overall quarter performance remaining relatively unchanged from the previous quarter end, with the 10 year and 2 year up just 5 basis points and 15 basis points, respectively. As such, market values remain steady from the previous quarter end. The 2-year/10-year spread remained inverted in the fourth quarter, in addition to the 5-year/30-year spread. This inversion means that the 2-year Treasury offered a higher yield than the 10-year Treasury and the 5-year Treasury offered a higher yield than the 30-year Treasury. Inversion of the yield curve has historically been an indicator of recession which has proven to be reliable.

**Domestic Equity Market** - As with the Fixed Income Market, the NASDAQ finished the quarter relatively unchanged from the previous quarter end down 1.03%. The S&P 500 fared better within the quarter, finishing up 7.08%. While the market still faces challenges with unemployment and tightened monetary policy, notable positive occurrences in the quarter were continued releases of strong corporate earnings and the ease of inflation. Additionally, while the yield curve remains inverted, this is generally a positive indicator for the equity market longer term with the S&P 500 trending upwards each of the last four inversion occurrences.

**Summary** - Q4 2022 wraps up a very tumultuous year in regards to market fluctuation and activity. While this year posed many challenges, opportunities remain for strong investment decisions. We look into 2023 with optimism of a more balanced economy with reduced inflation, strong employment figures, and a recovering market. However, these changes will be closely monitored based on the Fed's monetary policy and how investors respond.

# Yield Curve & Spreads



**Trevor Rupe, CFA**  
**Portfolio Manager**

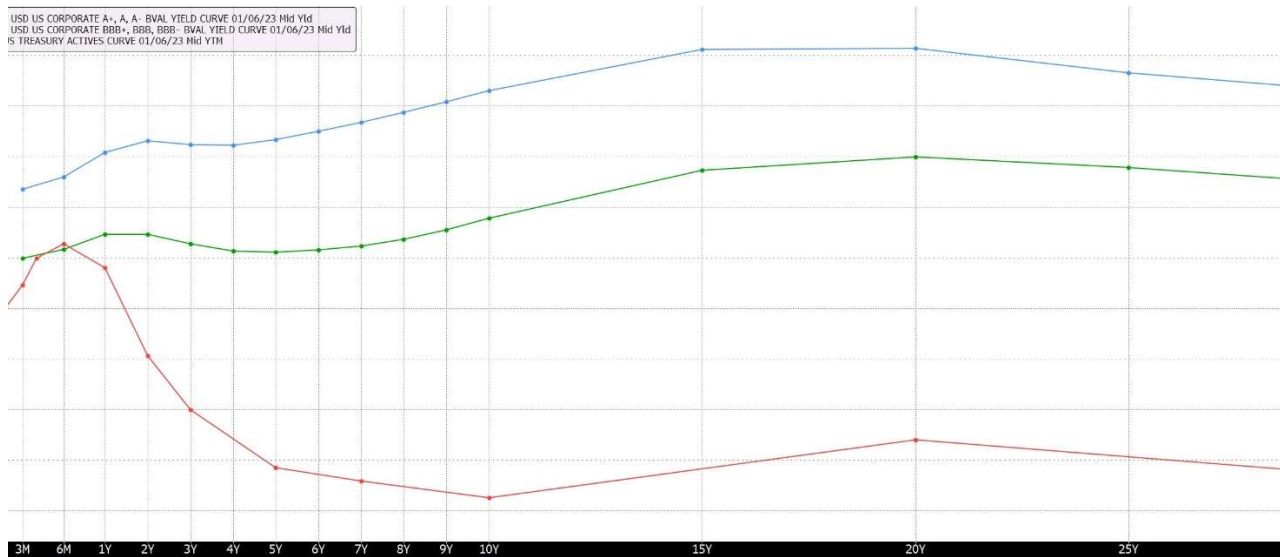
A big topic of conversation throughout the past year has been the inverted yield curve. While this occurred briefly in August of 2019 and in April 2022, the curve has essentially been inverted from July 2022 through the time of this writing. In this piece, I will discuss the specifics of what the event entails, plus the historical significance of inversions, but most importantly what this means for you and your fixed income portfolio.

An inverted yield curve in the most simplistic terms means that you are able to achieve higher yields on shorter term investments relative to longer term purchases. While inversions can occur across the curve, the most commonly watched metric is the difference in the yields of 2 & 10-year Treasury bonds. When the 2-year Treasury yield is higher than the 10-year, the curve is considered inverted. The curve is currently the most inverted it has been in over 40 years with the 6-month Treasury yielding 4.80% compared to a 10-year yield of 3.56% at the time of this writing.

Why is this important? Historically, anytime the curve has inverted, a recession has subsequently followed within the next 18 months. Reasons vary for the exact cause of the inversion, namely Fed action or inflation concerns, but a general cause can be linked to investors willingness to “lock in” yield for a longer duration. More specifically, investors are betting that rates will fall in the future so would rather hold on to a 3.55% yield for 10 years despite shorter higher yields offering better relative value. What do you do with this? First and foremost, the main focus of any insurance company should be an Asset Liability Management (ALM) strategy. In short, this means you are purchasing investments that make sense for the products and cash needs of the organization. While selling a 5-year annuity product at 4% and purchasing a 6-month Treasury at 4.80% may net a positive spread in the short term, this leads to an ALM mismatch and potential issues if that bond matures in a lower interest rate environment and you are forced to invest at a lower yield. This either reduces profitability, or worst case, a negative spread. However, with surplus dollars, those in excess of dollars earmarked for specific liabilities, targeting the best value on the curve is absolutely appropriate.

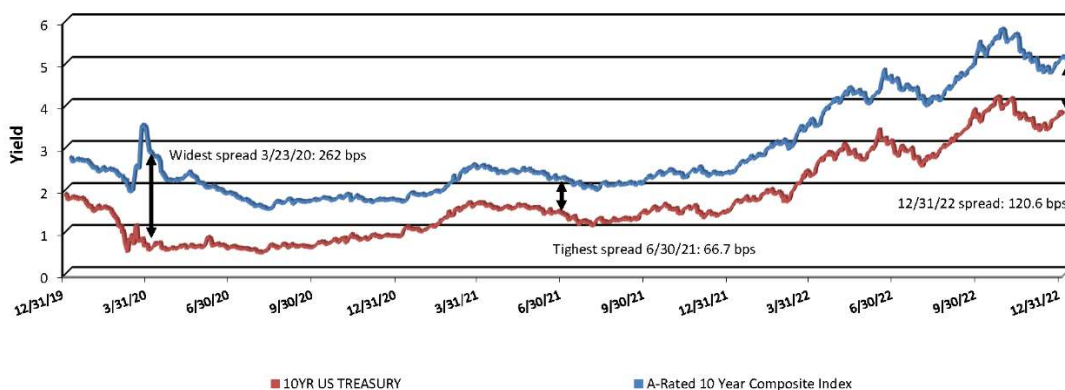
When talking about the yield curve, it generally is in reference to the yields on Treasury securities. Another major consideration to take into account is spread. Spreads represent the additional return that credit securities (corporates, municipals) offer over a Treasury security. As seen on the next chart, when you account for spreads, credit securities (green line represents average yields on “A” rated corporate and blue represents yield on “BBB” rated securities) are far less inverted than their Treasury counterparts.

## (Yield Curve &amp; Spreads Cont'd)



Another way to think about spreads is to view them as the perceived additional risk a credit security has over the “risk free” Treasury. When the economy is doing well and investors are less concerned with the going concern of corporations, that spread will be lower and a corporate bond may only offer modestly higher yields compared to government securities. However, during times of duress or uncertainty, you generally see spread widen as investors perceive a higher risk within credit securities. This is apparent in the following chart, as you can see the spread between a 10-year A-rated corporate bond and the 10-year Treasury widened considerably during March of 2020 when the world was reeling from the potential impacts of COVID-19.

## 10yr Yield &amp; Spread



*(Yield Curve & Spreads Cont'd)*

The major point I want to drive home is there is more to the story than just the yield curve conversation. Due to the spread component, which are more volatile on lower rated securities, quality should remain another top priority for insurance companies. Even though Treasury yields may fall due to Fed action, inflation concerns subsiding or even a recession, losses can still occur due to spreads widening to larger degree than the positive impact falling yields have on bond prices. A general rule of thumb is “A” rated corporate bonds generally have a spread of ~100 basis points, which is close to the 120-basis point spread they ended 2022 with. So, with some uncertainty on the horizon with recession concerns dominating headlines, it is certainly a possibility to see them widen in the near term.



# Accounting & Reporting Updates

## Negative IMR



Probably the most discussed topic in the financial industry in 2022 was interest rate movements. The Fed Rate increased over 400 basis points in 2022, the 10 Year Treasury rose from 1.63% at the beginning of the year to over 4% in November, and the 3 month LIBOR started at 0.216% and ended at 4.76%. This drastic change had a significant impact on the insurance industry. One area of interest for life insurance companies that has arisen is the impact on IMR. The purpose of the IMR is to protect surplus from disposals due to interest rate changes, and it minimizes the effect of gains or losses over the approximate remaining life of the securities sold.

Because of the rising interest rate environment, fair values of fixed income securities have fallen. This has caused many life insurers and their advisors to reconsider investment decisions they otherwise would have made due to the effect it could have on the company's IMR. A negative IMR is non-admitted on the annual statement. In previous years, this may have not been an issue, because we had been in a falling interest rate environment since the 1980s into 2021, which became magnified after the 2008 financial crisis.

The NAIC has had several meetings and calls to see what needs to be done to alleviate the effect this could have on insurers and the industry as a whole. The SAPWG, with representatives from LATF, will be meeting in regulator-only sessions to receive company-specific presentation as to this topic. Conversations have started and will continue into 2023. Comments are due February 10<sup>th</sup>. The NAIC should include this as an item on their maintenance agenda as a new SAP Concept. It looks hopeful that there will be a resolution in 2023.

The negative IMR dilemma was brought to light in a letter from Mike Monahan at the American Council of Life Insurers to the NAIC at the end of October. The NAIC pointed out a couple of key positions. One, in general, rising interest rates are favorable to the financial health of the insurance industry and policyholders. However, with negative IMR, there could be a perception of decreased financial strength through lower surplus and risk-based capital. Two, negative IMR could impact the rating agency view of the industry or incentivize companies to avoid prudent investment transactions that are necessary to avoid mismatches between assets and liabilities. In either scenario, negative IMR encourages short-term non-economic activity that is not in the best long-term interest of a reporting entity's financial health or its policyholders. Monahan also points out that the disallowance of negative IMR is "contrary to its original intent which recognized that interest gains and losses are both transitory without any true economic substance since the proceeds would be reinvested at offsetting lower or higher interest rates, respectively." He presented the attachment below in his letter.

## (Negative IMR Cont'd)

## Attachment I

**Simplified Example – Need for Reporting Assets, Liabilities, and Income on a Consistent Basis:**

- This example shows the appropriate interrelationship of IMR on assets, reserve liabilities, and income.
- Assume a bond is held with the following characteristics:
  - Par Value: \$1,000
  - Coupon: 3%
  - Term-to-maturity: 10 years
- Assume the bond is then sold at “time zero” and the proceeds are immediately reinvested in a bond with the same characteristics (e.g., term-to maturity, credit quality, coupon equivalent to market rate, etc.).
- Assume a simplified example with no existing IMR balance, where the bond supports a fixed insurance liability with the same duration as the original bond, as well as a present value of \$1,000.

Table 1: Market Interest Rate Scenario			
	Same	Lower	Higher
Market interest rate	3%	2%	4%
Bond's market value	\$1,000	\$1,090	\$919
Realized gain/(loss) if sold	\$0	\$90	(\$81)*

Realized gain/(loss) deferred to balance sheet IMR and amortized into income over remaining life of bond sold (i.e., 10 years).

Table 2: Statutory Investment Income			
IMR amortization	\$0	\$9	(\$8)
Interest income on new bond	\$30	\$21	\$38
Total annual stat income	\$30	\$30	\$30

On average, future income is approximately the same in each interest rate scenario as the IMR gets reduced through amortization to income.

Table 3: Statutory Balance Sheet			
Balance Sheet Bonds	\$1,000	\$1,090	\$919
IMR	\$0	(\$90)	\$0*
Stat assets net of IMR	\$1,000	\$1,000	\$919*
Reserves	\$1,000	\$1,000	\$1,000
Surplus	\$0	\$0	(\$81)*

Even though the sale of the bond (and subsequent reinvestment) is non-economic, and the same income is being produced to support the liability, a negative surplus position makes it appear there is now a deficiency. Allowing the negative IMR appropriately would show no surplus impact, as is shown when a gain occurs, as there is no change in reported reserve liabilities.

Appropriately consistent financial results require the allowance of negative IMR

\*The negative IMR balance is currently disallowed and directly reduces surplus. This treatment is not supported by theoretical rationale and gives a distorted view of solvency.

Monahan's argument is that the disallowment of IMR is not supported by theoretical rationale and gives a distorted view of solvency. An accurate view of the financial health of the insurance company would not be reflected in Principle-Based Reserves and Asset Adequacy Testing for actuaries. New entries into IMR are based on time, and not a sign of lack of financial strength or affects claims paying liquidity, but it presents a short-term optics problem until the IMR is fully amortized. One other concern that was brought up is the "double-counting" of capital losses, which is created by losses on the sell, but also is not made up in the offset by the surplus loss coupled with IMR gain liabilities.

The NAIC discussed the negative IMR predicament in its December meeting. It was pointed out that there was an IMR/AVR Working Group for about a decade after IMR/AVR were introduced (1992) but it was disbanded. One recommendation that was mentioned was companies that are approaching this situation, a negative IMR, should contact their domestic state insurance regulator about the potential for a permitted practice. "Appropriate" and "reasonable" are aspects to keep in mind when having the discussion of where to put the negative IMR.

The NAIC later released a white paper further discussing guidance. There was a mention that a rising interest rate environment has increased the likelihood for companies to move to a negative IMR. Maximum and minimums of the reserve were addressed. No maximum is placed on IMR, and the minimum IMR to be admitted is zero for the aggregate business, but it can be negative for any line of business. The basic rationale for the IMR would conclude that neither a maximum nor a minimum would be appropriate. It is assumed that the assets were purchased at the same time that the liabilities were established, and there should be no bounds to the reserve which corrects for changes in that assumption. If a company needs to set up a reserve because of taking gains, it would be in no worse shape than if it had the original assets. There is no adopted practice if a company needed to take losses that resulted in a negative reserve. There are many reasons that an insurance company would need to sell and end up with losses. Losses would be likely in a rising interest rate environment. Some examples of reasons for disposals would include ALM restructuring, re-insurance, funding unexpected claims (which became an issue from the COVID-19 pandemic and ongoing long COVID uncertainties), and to get ahead of potential credit losses that avoids losses flowing to AVR (e.g., current year effect). Companies also took losses from the prepayment treatment of calls and tenders that was introduced in 2018. All of these contribute to the IMR.

The NAIC whitepaper provided some data points on the reduction of IMR in 2022. Over 50 companies moved from a positive IMR to zero from the beginning of 2022 until the end of Q3 2022. Remember that negative IMR is not reflected because it should be reported as a non-admitted asset, so the reserve stops at zero. A limited



*(Negative IMR Cont'd)*

number of companies reported a net negative IMR balance in the third quarter for a total of over \$11MM. With the 2021 data included, out of 71 companies that had an IMR drop to zero, 60 companies were identified with a disallowed IMR for a total of \$1B as of the end of Q3 2022.

No changes have been made for year-end 2022, but there will likely be changes in the future. The first recommendation is for companies to contact the state regulators or insurance commissioners of their state of domicile for guidance. It would also be a good idea to have a conversation with the actuaries regarding the Asset Adequacy Testing Practices. Remember that the admittance or non-admittance of an aggregate (all lines of businesses) negative IMR would be principle-based, reasonable, and appropriate. As of now, without guidance, negative IMR would be non-admitted and the reported amount of IMR would be zero. The disallowed amount appears on line 25 of the assets page of the annual statement in the non-admitted column. Companies should report the change in the disallowed portion on Page 4, Line 41 (change in non-admitted assets) so the change will be appropriately charged or credited to the Capital and Surplus Account. We are looking for information from the NAIC if there is any chance of permitted practice on negative IMR for Year-End 2023. The NAIC has requested potential guardrails and details on unique considerations. This will be something that will be discussed and considered beyond 2022.

## Interest Rate Spreads

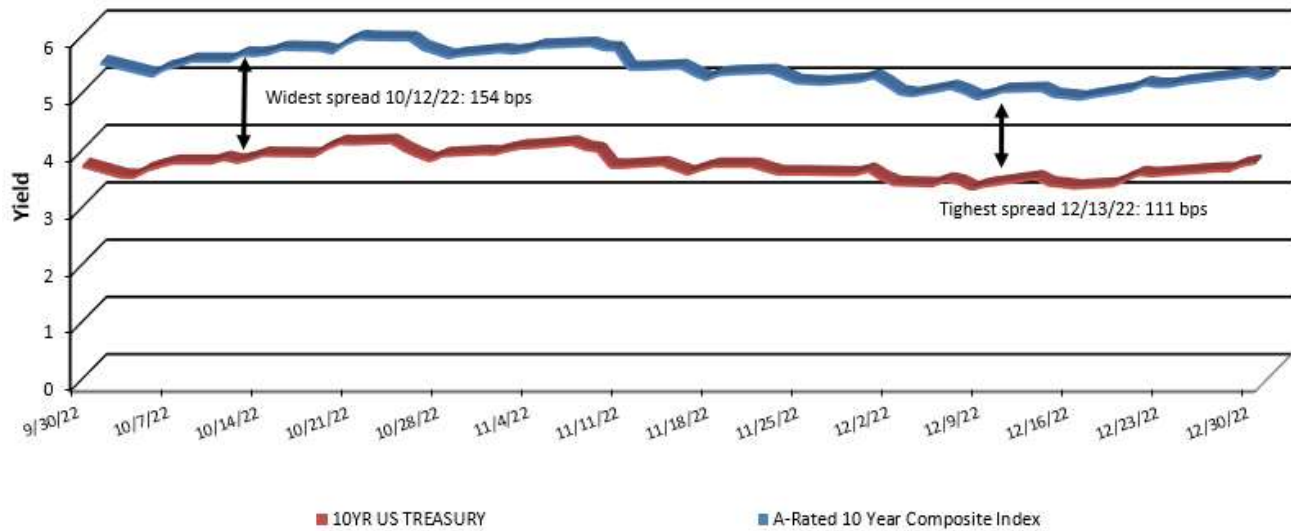
As of: 12/30/2022

Term	Treasury Yield	US Composite BVAL AA Curve Yield	US Composite BVAL AA Curve Spread	US Composite BVAL A Curve Yield	US Composite BVAL A Curve Spread	US Composite BVAL BBB Curve Yield	US Composite BVAL BBB Curve Spread	US Composite BVAL BB Curve Yield	US Composite BVAL BB Curve Spread
1yr	4.73	4.7428	0.0128	4.8808	0.1508	5.3065	0.5765	6.0717	1.3417
2yr	4.41	4.6992	0.2892	4.8751	0.4651	5.3495	0.9395	6.4396	2.0296
3yr	4.22	4.6265	0.4065	4.8352	0.6152	5.336	1.116	6.6421	2.4221
5yr	3.99	4.5809	0.5909	4.8406	0.8506	5.4062	1.4162	6.9095	2.9195
7yr	3.96	4.6131	0.6531	4.9242	0.9642	5.539	1.579	7.0987	3.1387
10yr	3.88	4.7166	0.8366	5.0919	1.2119	5.7293	1.8493	7.2697	3.3897
20yr	4.14	5.0686	0.9286	5.4192	1.2792	5.9603	1.8203	7.5805	3.4405
30yr	3.97	5.0867	1.1167	5.2825	1.3125	5.7352	1.7652	7.3391	3.3691

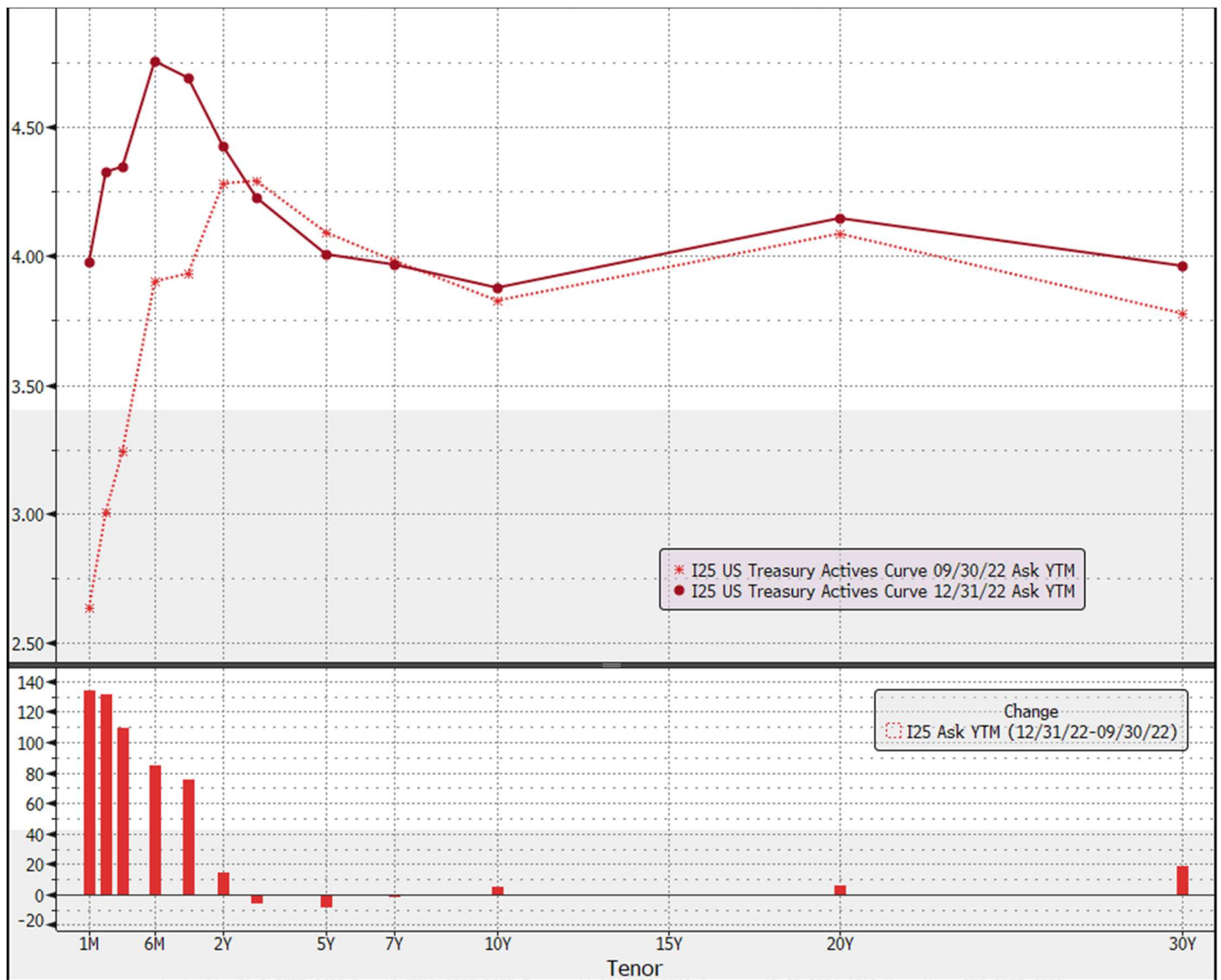
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## 10yr Yield & Spread

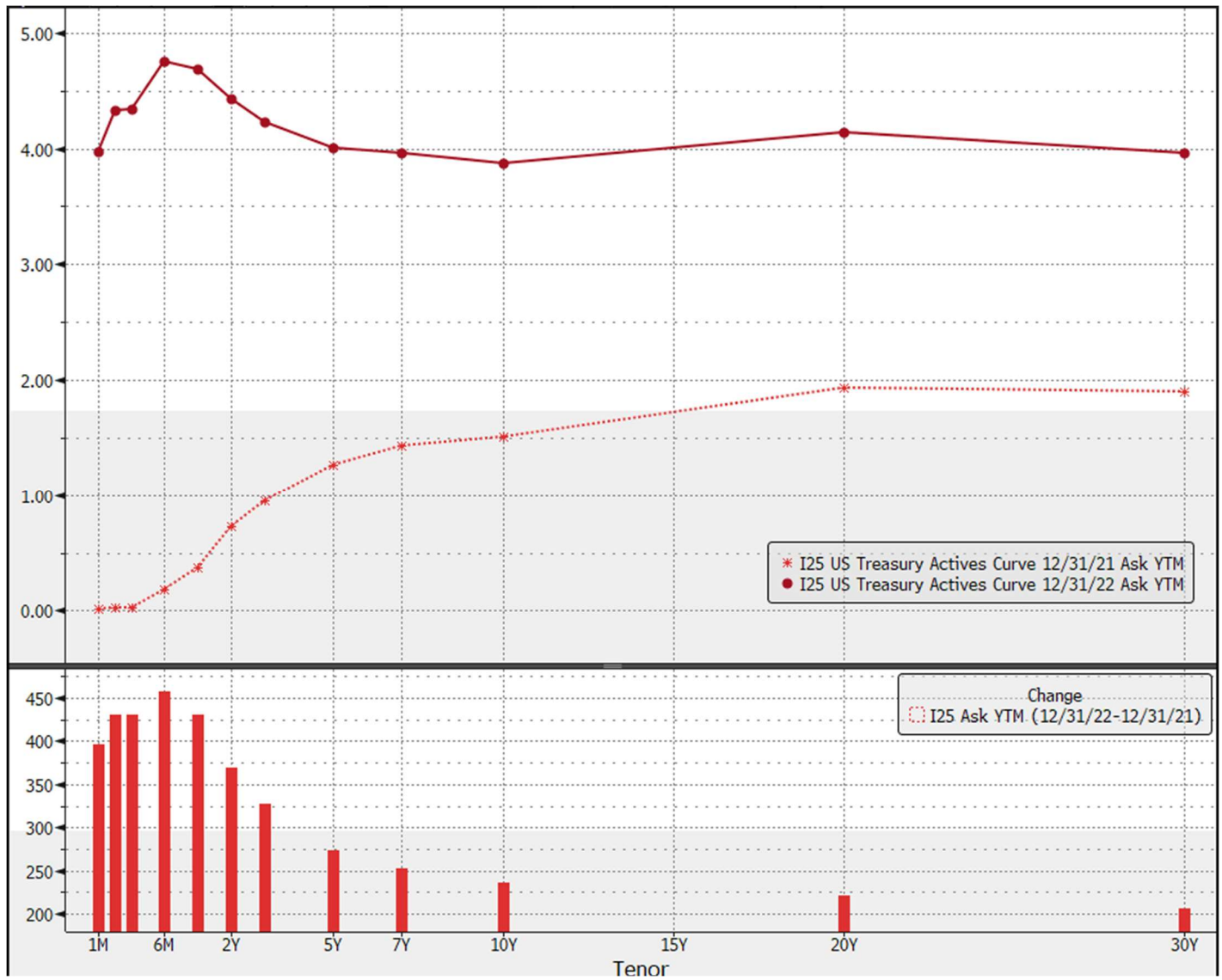
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## US Treasury Yield Curve 4th Quarter



# US Treasury Yield Curve YTD





# 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***

We welcome your inquiry and can be reached by mail at Parkway Advisors, L.P., P.O. Box 5225, Abilene, Texas 79608 or by phone at (800) 692-5123 or by fax at (325) 795-8521. A copy of our Form ADV, Part II is available upon request.

For more information, please email [info@parkwayadvisors.com](mailto:info@parkwayadvisors.com) or visit [www.parkwayadvisors.com](http://www.parkwayadvisors.com)