The Insurance *perspective*

2024- Volume 31

PARKWAYADVISORS

6550 Directors Parkway Abilene, TX 79606 800.692.5123

www.parkwayadvisors.com/

Follow us on

Economic Commentary

Investors rang in the new year with a sense of optimism, fueled by expectations that upcoming rate cuts will help bolster the positive momentum in markets ignited by the Fed in the prior quarter. As the quarter progressed, markets were faced with a reality check, as participants adjusted to the likelihood that the pace of cuts would likely be slower than they had hoped for at the beginning of the year due to sticky inflation. Equity markets took little notice, as they charged on to new all-time highs. They were supported by well-received corporate earnings and continued enthusiasm over artificial intelligence, still clinging on to the hope of rate cuts occurring later in the year. Given the prospect of a slower pace of cuts, bond markets sold off as interest rates ticked higher across the curve. Despite elevated rates, economic data shows a resilient economy with consumer sentiment continuing to step up.

Domestic Fixed Income Market

Volatility in the bond markets remained as rates stepped up throughout the quarter. After a sharp decline heading into year end, the 10-year Treasury rate rose 32 bps to finish the quarter at 4.20%, which remains well below the 5% peak in October. The Treasury curve remains inverted with higher yields offered on the front end, with the 1–3-month Treasuries yielding ~5.35% compared to the 2-year Treasury at 4.62%. This inversion is a display that market expectations point to lower yields in the future. Spreads on corporate bonds, which in part compensate investors for purchasing the credit risk of corporate issuers, tightened throughout the quarter. Spreads on a composite of 10-year single A-rated corporate bonds, the excess yield picked up over a 10-year benchmark Treasury bond, fell from 0.91% at the start of the quarter to a low of 0.61% on March 18th. Relative to historical averages, this points to market optimism over the creditworthiness and resilience of corporate issuers as investors are demanding less return for risk. While the broader bond market saw negative total returns in the first quarter from rising yields, the high yield sector did see a moderately positive return. High yield bonds are less interest rate sensitive, and their return is driven more by expectations over economic outlooks, highlighting the optimism of our short-term economy.

Domestic Equity Market

Equity markets experienced a broadening rally which continued throughout the first quarter. The “Magnificent Seven” were responsible for 60% of the S&P 500’s 2023 gains. Comparatively, those seven companies were only responsible for 40% of year-to-date gains for the index, as a broader pool of winners propelled the markets forward. The S&P 500 wrapped up the quarter with a strong gain of 10.55%, along with a 9.32% return for the tech heavy NASDAQ. Small caps underperformed with a 5.17% return for the quarter, however they are up over 30% from their October 2023 lows, in-line with the S&P 500. Artificial intelligence continues to be a source of optimism for equity markets, as investors are looking for implementation of the technology to become a catalyst for growth in long-run economic productivity. Additionally, corporate earnings have proven resilient despite

higher borrowing costs and have resultingly provided support to the outlook for equity markets this year. Current analyst projections are for corporate earnings-per-share to grow 6.22% in 2024 and 6.82% in 2025. This points to an overall market capable of tolerating the elevated borrowing costs that markets are expecting to persist, making a case justifying current multiples in a soft-landing scenario. Despite optimism, the S&P has still returned over 27% from the October low, which in itself could warrant a pullback should any negative expectations emerge.

Federal Reserve

The Fed has remained persistent in their monetary policy outlook, holding rates steady despite initial expectations that cuts would begin in the middle of 2023. The market expectations on the pace of interest rate cuts at the beginning of the year proved too optimistic given incoming economic data and inflation readings. Inflation, which has cooled substantially from the 9.1% year-over-year pace in June 2022, has begun to stagnate, remaining persistently above 3%. The Fed remains firm in bringing this down to their long-run target rate of 2%. Despite their restrictive policy, strong corporate earnings and a firm labor market have enabled the Fed to maintain elevated policy rates. This has muted the recession fears of economists, as the Fed appears capable of achieving a soft landing, where they cool inflation with restrictive policy without substantial negative effects on GDP growth and labor markets. This correction has brought market pricing to match the Fed dot plot, with current expectations now of only three rate cuts this year, to begin in the 3rd quarter. Given the resilience of the economy, we view this pace as manageable with the possibility for even less cuts than projected this year.

Summary

Market participants have misjudged an array of variables over the last several years, including the length of the hiking cycle, duration with which the Fed would maintain rates, and the recession risks higher rates would bring. While markets may not be out of the woods yet, current data makes a case that investors can be comfortable that markets can withstand higher rates for longer than expected. Recession probabilities have steadily trended lower since the middle of 2023, down from 65% to 35%. From here it will be important to monitor the direction and pace of inflation, along with signs of weakening in economic data and labor markets, and any adjustments to those that would prompt the Fed to change course. Despite the restrictive monetary policy we are currently living in, investors can look for more signs to be optimistic as the Fed likely begins their cutting cycle later this year.

Industry Insight

What allocation to the equity market is appropriate for an insurance company and what approach should be developed around an appropriate allocation? This is a question that I am often asked and have written on historically within the Perspective. As it has been requested again as a topic for the Perspective, I thought I would expand upon my past observations.

The S&P 500 wrapped up the 2023 year with an impressive 26.25% return in 2023. The most notable performance occurred at the end of the year with an almost 12% return during the quarter alone. This record-breaking trend continued in the first quarter of 2024 with a strong gain of 10.55%, along with a 9.32% return for the tech heavy NASDAQ. With this positive momentum, some insurance companies have experienced appreciation and question if any reduction in exposure is warranted. Other Insurers were left wondering if they had enough allocated to the asset class, considering the recent momentum.

Like many investment issues for insurers, the appropriate answer varies dramatically from one organization to the next. It also varies depending upon the type of insurer and the specifics of any possible reinsurance program. An observation from reviewing the allocations of many insurance companies is that an average life company will often have between 0 – 20% exposure to the equity market, while a P&C insurer might range as high as 40%. While it is good to see what peers are doing, the appropriate allocation for any single insurer should not be based upon a competitor. Two organizations of the same asset size, in a similar location and selling similar insurance products may need separate equity strategies. I will cover some of the main topics that must be considered in order to answer the questions above. As I progress through a series of questions to consider, I will be using a hypothetical insurer as an example.

Equity exposure increases surplus volatility - The majority of the assets of an insurer are carried on the books at amortized cost. This basis of statutory accounting was created in order to focus an insurer on cash flow in order to protect members/policy holders. The fundamental key is the production of asset cash flows that support the outgoing cash flows of the liabilities. Unlike fixed income, common stock is carried on the books of an insurer at market value. This is due to the fact that equity cash flows are not contractual. This means that the overall book value of assets will increase or decrease with changes in the value of the equity holdings. This aspect of statutory accounting, by regulatory design, creates surplus volatility.

(Industry Insight cont'd)

Consider surplus as a percent of total assets - As common stock increases surplus volatility, it is important to consider the risk you can take as it relates to surplus. If your organization cannot assume additional surplus volatility due to the ALM strategies, cash flow needs, RBC, surplus concerns, or risk preferences, it is not an appropriate time for you to invest in common stock regardless of how tempting the markets might appear. When surplus as a percent of total assets is below 4%, several financial concerns can start to occur. In these situations, it is appropriate to consider if equities should be avoided or limited. The primary reason exposure is often higher for the P&C insurers is directly related to an average higher capital & surplus ratio. This is often a product of reinsurance programs.

Consider the impact in a worst-case scenario - As an organization serving your policyholders, it is important that investment decisions focus on the long-term financial health and stability of the organization. This is why it is important to consider a worst-case scenario of any single asset or asset class. Basically, you do not want a single scenario to exist that would call into question the going-concern of the organization. A good question to ask is, "what is the minimum level of common stock exposure that would end the going concern of the organization if the equity markets realize a substantial decline in value?" Let's look at the following example scenario. The adjusted surplus level of our example company is $8 million (8MM) and we will assume that the authorized control level of RBC is $1,000,000. This means that the total "adjusted" surplus of the organization must be above this number. Currently there is approximately a $7MM cushion above this RBC level. However, most states require surplus levels around three times the authorized control level. Otherwise, many additional restrictions apply. In this scenario, a 50% decline in equity markets would place the example company below state required levels with an equity allocation of $10MM or greater. This establishes that, for our example, an allocation to common stock needs to be well below $10MM.

Consider surplus - The range above is only to define the absolute borders of any allocation. We can assume that the actual maximum appropriate allocation should be nowhere close to 100% of surplus as it would be imprudent to have an allocation near a level so potentially dangerous. As common stock generally appreciates over time, an allocation to equity can enhance unassigned funds long-term. Insurance regulation is built around ensuring that cash flow is available to provide for liabilities. This is why bonds are carried at amortized cost under statutory guidelines. Basically, any equity allocation is somewhat of a bet in the short run and is best served as a portion of surplus. One could also assume that in a recession, problems would also occur in other areas of the portfolio; therefore, a 20% additional markdown would provide assurance to the typical insurer with high diversification and a good ALM program in a typical recession, regardless of the severity. This helps additionally define the optimal level of exposure between 0 and $6.4MM.

Likely corrections and the impact to the gain from operations - While a severe recession, like the financial crisis of 2008 or the current pandemic, might occur relatively infrequently, 5 and 10% corrections happen regularly. In addition, a 20% correction should be anticipated to have a high probability of occurrence every 5 – 7 years. This is why considering how these scenarios would impact the organization is helpful in determining how much risk your organization might be willing to accept. Assume the net gain from operations in our example is $1,000,000. Risk adverse insurers with a positive gain from operations often desire to keep net gain positive. A

possible option is to limit equity exposure to the level that a 20% decline in equities would continue to allow a positive gain from operations to be realized. Depending upon your own risk tolerance and any potential impact to the total financials, you can adjust these targets to the specifics of your organization. In our example, this type of strategy would limit the maximum exposure to common stock at $5,000,000.

Consider other assets carried on the books at market value - Common stock exposure cannot be considered in a vacuum. Any assets carried at market value need to be considered within the limits you establish for any equity exposure. If your organization has $2,000,000 in other assets that are marked-to-market and these assets are highly correlated to common stock, it would be prudent to further limit the maximum equity allocation by this amount.

Consider how equity exposure is viewed by regulators and rating agencies - It is also important to consider how regulators and rating agencies view exposure. AM Best bases its rating in part on their BCAR score and other aspects on subjectivity. The score and outlook can be negatively impacted when exposure to any assets that are marked-to-market exceeds 50% of surplus. It is my observation that state regulators often have additional concern when these assets exceed 50% of surplus as it creates volatility. When a life company sells a high amount of annuity products, or a mutual has reinsurance risks, this often becomes a deeper concern. For these reasons, many insurers decide to set the max allocation at 50% of surplus. In our example this would establish an appropriate range of 0 to $4,000,000 in securities that are marked-to-market.

Impact to AVR and RBC – The Asset Valuation Reserve (AVR) is a credit quality reserve for life companies that pulls funds from surplus in order to buffer the organization in the event of problems. As the NAIC views common stock as one of the highest risks, this asset class carries a high reserve between 10% and 20%. Understand that an initial investment in common stock of $5,000,000 could increase AVR by as much as $1,000,000, resulting in an equal decline of surplus on day one of investing. While this factor only affects the Life and Health industry, both Life and P&C companies are concerned about Risk Based Capital (RBC). The increased risk of an equity portfolio also requires a very high C1 factor held against the portfolio for the purpose of calculating Risk Based Capital (RBC). For many organizations, RBC is a top concern; therefore, it is important to consider this.

Actual Allocation Decisions - It is important to establish an initial range based upon the parameters discussed above. However, any actual allocation within this range must be tailored considering the unique risk tolerances and circumstances of each organization. In our simple example, we established an absolute range between 0 at the low end and $4,000,000 as the maximum allowed exposure. Once a range is defined for your organization, I would recommend that the initial allocation or target is set below any maximum limit in order to allow for appreciation. One strategy might be to set limits within the 50% of surplus target and based upon the total net income in the previous year. A 30% surplus allocation would set a range between 0 and $2.4MM in our example and an initial target allocation might be established at $0–1.9MM depending upon the specific risk tolerance of the example company.

On this basis, an insurer can establish allocation minimums and maximums within the investment plan. Once established, various funding strategies can be designed depending upon the risk tolerance of the insurer. I often recommend a slow and steading funding approach. Additionally, Insurance companies have a unique advantage over many investment portfolios as they often have well designed or "laddered" cash flows from the bond portfolio. This helps create the opportunity to reduce equity exposure when markets are at all-time highs, like we currently see. Then when the markets pull back, cash flows are available for equity investment as the declines are occurring.

While the above information provides a template for appropriate allocations to equities, any program should also be tailored to the risk tolerances of the stakeholders of the company and documented within a policy within the investment plan. While it is easy to get allured by the seemingly ever-increasing market, an insurance company should not adjust an already well-established investment plan just to simply chase return. The overall program needs to be part of a long-term focus designed to mitigate risk and provide an appropriate long term return.

Implementing Change

Overview of the Blanks Working Group's Adopted Charges and Proposals for 2024

Matthew Eurek
Investment Accountant

As is the case for most of us, the turn of the new year in January presented an opportunity for implementing changes to our daily lives. The turn of the new year also served as a time to manifest change for the better within the insurance accounting landscape. Which is exactly what the NAIC's Blanks Working Group has set out to do with their new set of adopted charges, where they aim to enhance their approach to their practices and procedures for 2024 and beyond. The insurance industry has been subject to continuous change over the years, and the working group cast their net over a vast area targeting three central themes in their nine listed charges, those of which can be categorized by how they intend to coordinate, what is being considered, and items they are monitoring.

Coordination is vital to any entity, and the NAIC and its' respective task forces and working groups are not an exception to such. In hopes to improve efficiency and effectiveness of their efforts, the Blanks Working Group indicated that they intend to maintain coordination with the other NAIC task forces to ensure that there is a smooth implementation of proposed changes across any interrelated areas. There were two specific matters of coordination that were addressed in the Blanks Working Groups 2024 Adopted Charges. The first pertains to the ongoing efforts of the Capital Adequacy Task Force and its relation to the intricacies of the investment schedule blanks and instruction changes. The second being that they are reviewing and coordinating with the Valuation of Securities Task Force to ensure that the back end of the investment reporting schedules, and the corresponding instructions are consistent with the requested changes regarding other invested assets reporting. They also cited that they are coordinating with the relevant task forces and working groups to prevent duplicate annual and quarterly statement blanks reporting.

The Blanks Working Group also detailed items that they intend to consider within their list of Adopted Charges for 2024. Atop the list of charges for 2024, the working group listed that for consistency's sake they are considering how they can go about aligning the annual/quarterly statement blanks with those that have been altered by separate task forces and working groups of the NAIC so that the insurer's financial reporting process is improved. The group is also cognizant that proposals have been made that would streamline reporting. The proposals in reference aim to shed extraneous data elements, financial schedules and disclosures that are no longer pertinent. However, the working group made note that any revisions that could be made to reporting if adopted would still meet the respective regulations and that the relevant task forces would be coordinated with to ensure such.

Additionally, the Blanks Working Group indicated that they intend to review and enhance the various annual/quarterly statement blanks.

Whether it be monitoring the progress of their prior endeavors or keeping up with the ever-changing landscape of the insurance industry, the Blanks Working Group aims to stay alert in 2024. In their efforts to stay current with regulatory changes, the group is committed to maintaining up-to-date filing requirements by monitoring each state's filing checklists. Item three of 2024's adopted charges indicates the continuation of their efforts to track financial data that has been and is being submitted by insurance companies in hopes to improve such through the revision of the Annual Statement Instructions to ensure that what is outlined is clear so that what is being filed is accurate. Furthermore, the Blanks Working Group cited their intention to oversee and align all proposed implementations for statutory guidance pertaining to the annual financial statements and their instructions with the Accounting Practices and Procedures Task Force to ensure that there is cohesion between the two.

In regard to changes that have already been adopted, in November of last year there were two proposals of note that will take effect in the first quarter of 2025 concerning modifications to annual/quarterly financial statements and instructions. The two proposals listed below are for Health, Life/Fraternal, Property/Casualty, Separate Accounts and Title insurers. Below you can find the detailed description of such along with the corresponding reference number.

- 2023-06BWG Modified – *Split Schedule D, Part 1, into two sections: one for Issuer Credit Obligations and the other for Asset-Backed Securities (ABS). Update the other parts of the annual statement that reference the bond lines of business.*

- 2023-07BWG Modified – *Update the Code column and delete the Legal Entity Identifier (LEI) column for the following investment schedules: Schedules A, B, BA, D Part 2, D Part 6, and E Part 1.*

In addition to those listed above, the Blanks Working Group also adopted the following proposal this February that aims to provide additional clarification under Note 5, which is set is to take effect for the 2024 annual statements. The following proposal is for Health, Life/Fraternal, Property/Casualty, and Title insurers.

- 2023-13BWG Modified – *Add new instruction and illustration under Note 5 – Investments for Net Negative (Disallowed) Interest Maintenance Reserve (IMR) and a new general interrogatory for a company attestation.*

More in-depth detail of these newly adopted proposals can be found on the NAIC official webpage.

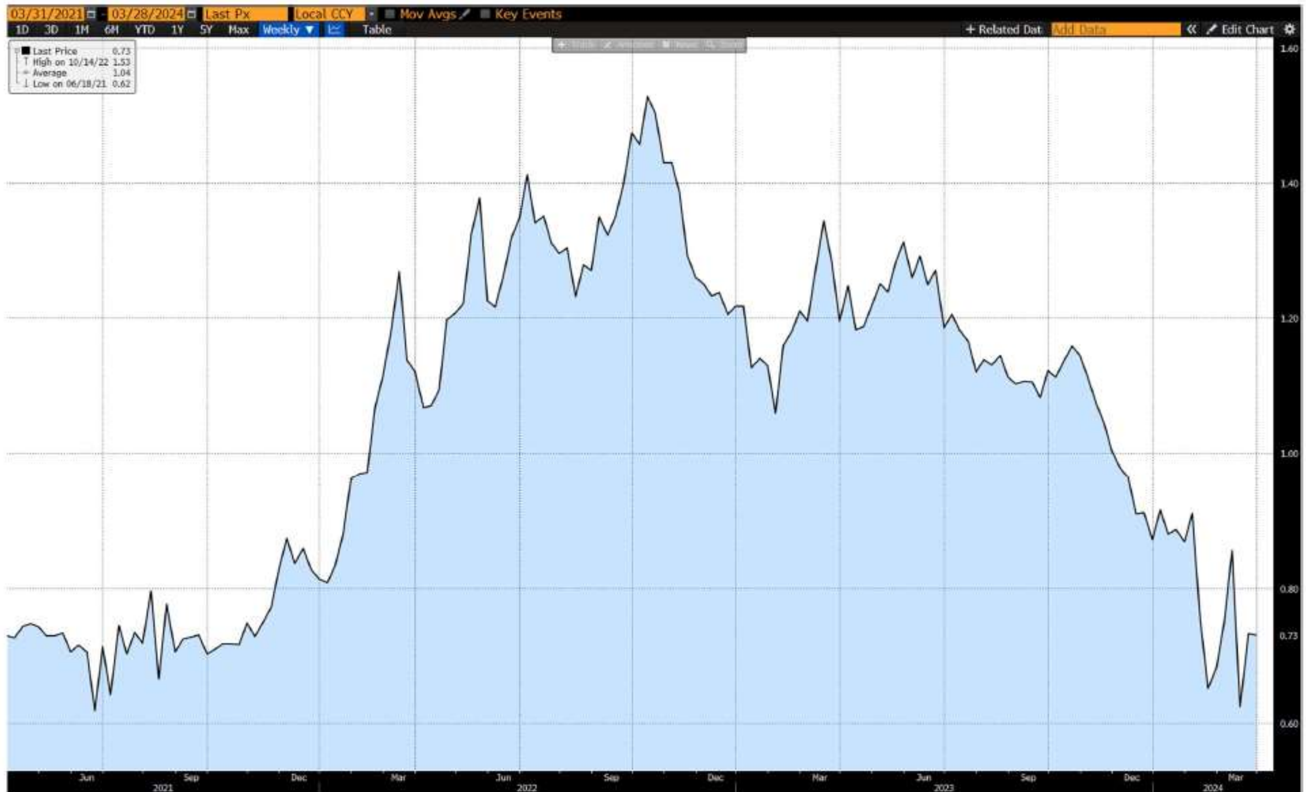
Interest Rate Spreads

As of: 3/31/2024

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	5.03	5.1678	0.1378	5.3222	0.2922	5.6683	0.6383	6.0038	0.9738
2yr	4.59	4.8355	0.2455	4.9797	0.3897	5.3368	0.7468	5.9343	1.3443
3yr	4.4	4.677	0.277	4.845	0.445	5.2132	0.8132	5.9742	1.5742
5yr	4.21	4.606	0.396	4.7906	0.5806	5.1609	0.9509	6.1836	1.9736
7yr	4.2	4.6591	0.4591	4.8991	0.6991	5.3001	1.1001	6.384	2.184
10yr	4.2	4.7996	0.5996	5.0833	0.8833	5.4837	1.2837	6.5691	2.3691
20yr	4.45	5.105	0.655	5.3787	0.9287	5.7361	1.2861	6.8228	2.3728
30yr	4.34	5.0802	0.7402	5.3107	0.9707	5.635	1.295	6.6216	2.2816

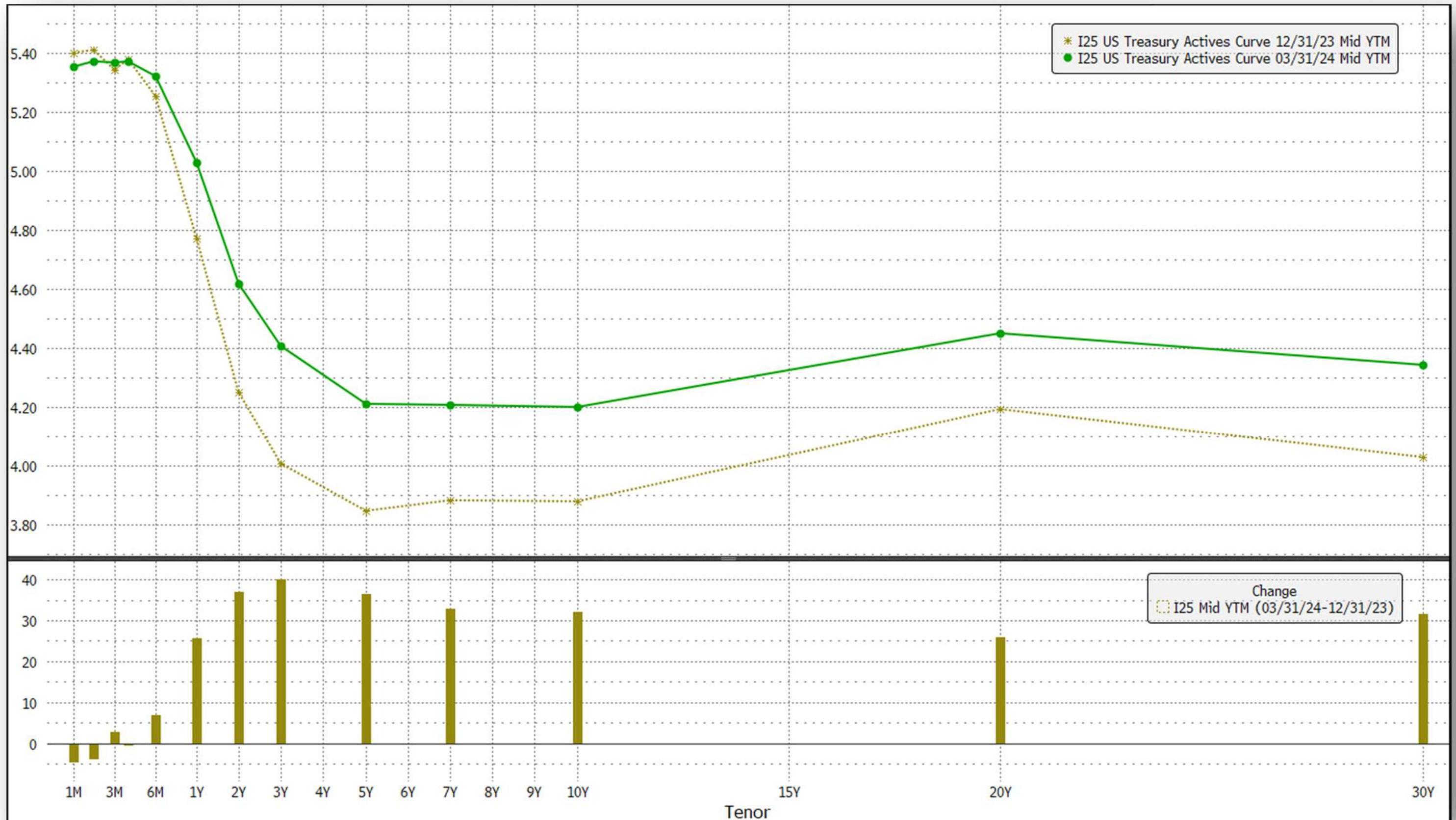
Disclosures: This material is for your use only and is based upon information which we consider reliable, but we do not represent that it is accurate or complete and should not be relied upon as such. Information was obtained from Blooomberg and represents the respective Bloomberg US Composite BVAL and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

10 Year A-Rated Corporate Spreads

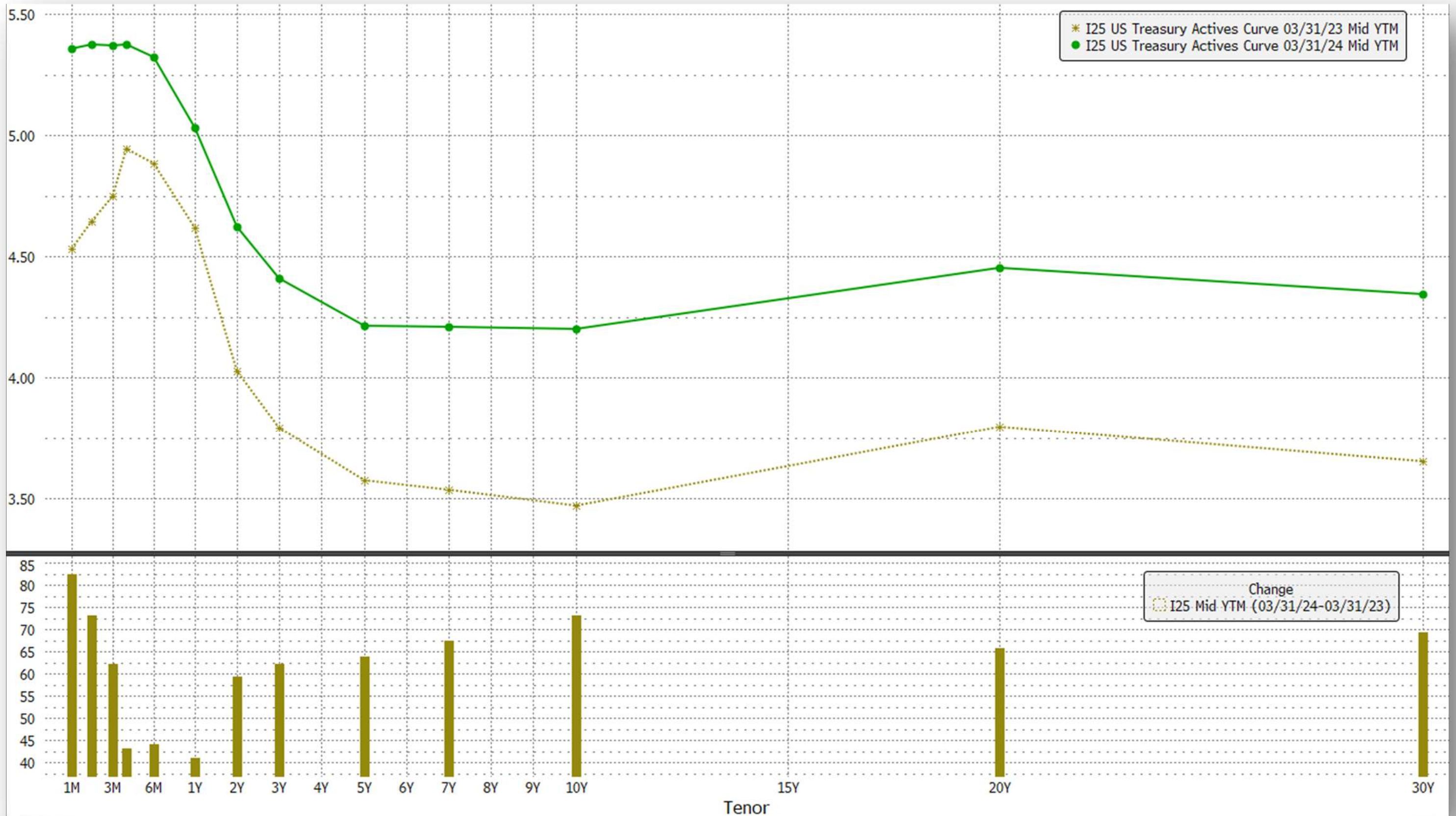


Spreads on a composite of 10-year single A-rated corporate bonds, the excess yield picked up over a 10-year benchmark Treasury bond, fell from 0.91% at the start of the quarter to a low of 0.61% on March 18th. This is a continuation of spreads tightening over the last year and a half.

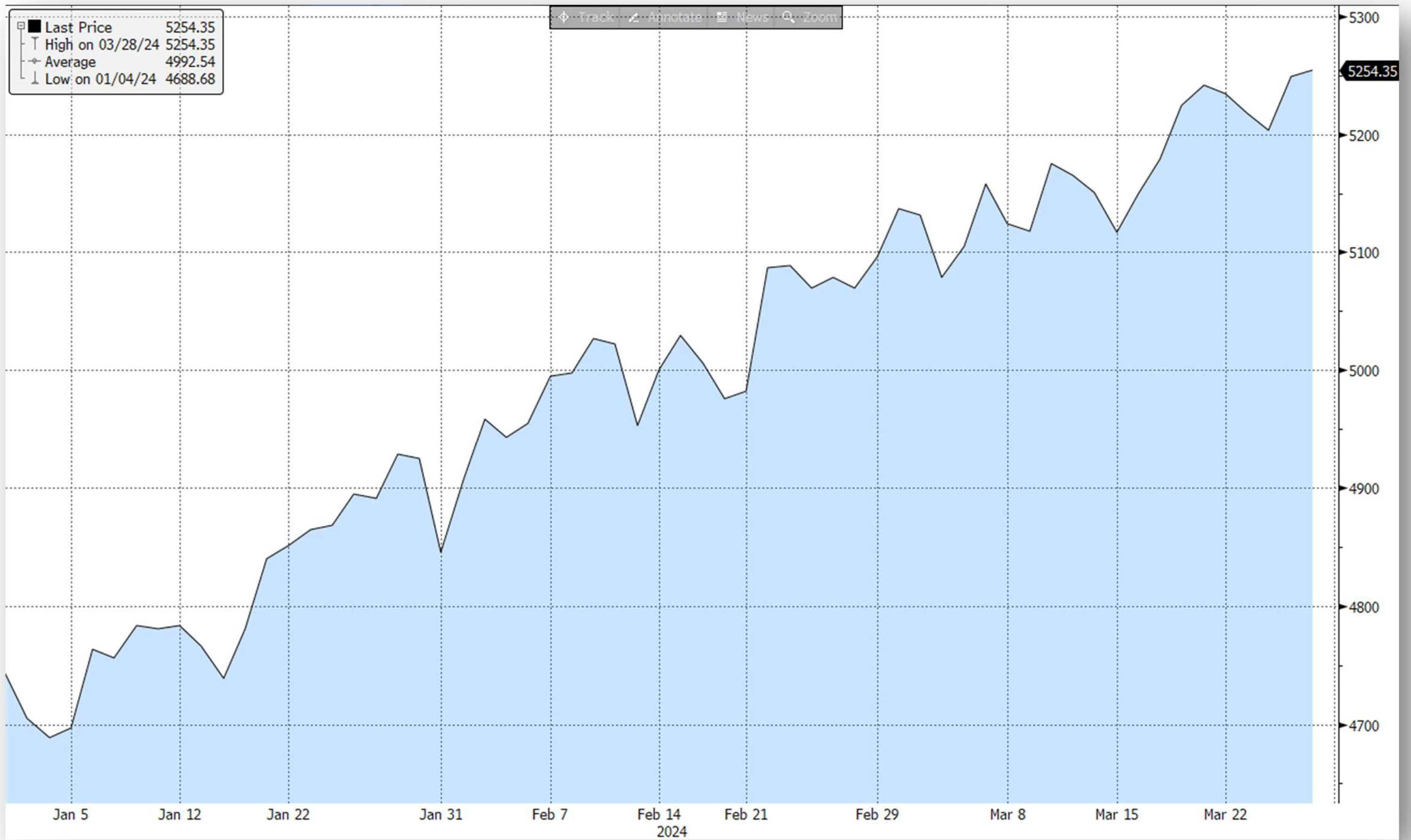
US Treasury Yield Curve 1st Quarter



US Treasury Yield Curve YTD



S&P 500 Index



Dow Jones Industrial Average

Russell 2000 Index

Disclosures

Parkway Advisors, L.P. is an investment advisor registered with the Securities and Exchange Commission offering investment management, consulting, and statutory reporting services. This material is for your use only and is based upon information obtained from various sources which we consider reliable but has not been independently verified and thus we do not represent that it is accurate or complete and should not be relied upon as such. Graphical and tabular 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. The opinions expressed are our opinions only. Past performance is no guarantee of future performance, and no guarantee is made by this document.

About this Publication

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 or visit www.parkwayadvisors.com