

December Fed Fund Rate Increase and Impact on Universal Life Crediting Rates

Overview

On December 16, 2015, the Federal Reserve (Fed), as widely expected, approved a quarter-point (0.25 percent) increase in its target funds rate. The new target is now 0.25 percent to 0.5 percent (up from 0 percent to 0.25 percent). This is the first Fed fund rate increase in more than seven years.

Over the past 25+ years, universal life (UL) crediting rates have been declining due to lower insurance company portfolio yields in a declining interest rate environment. With the Fed's recent action, many are wondering if the end of declining UL crediting rates is near.

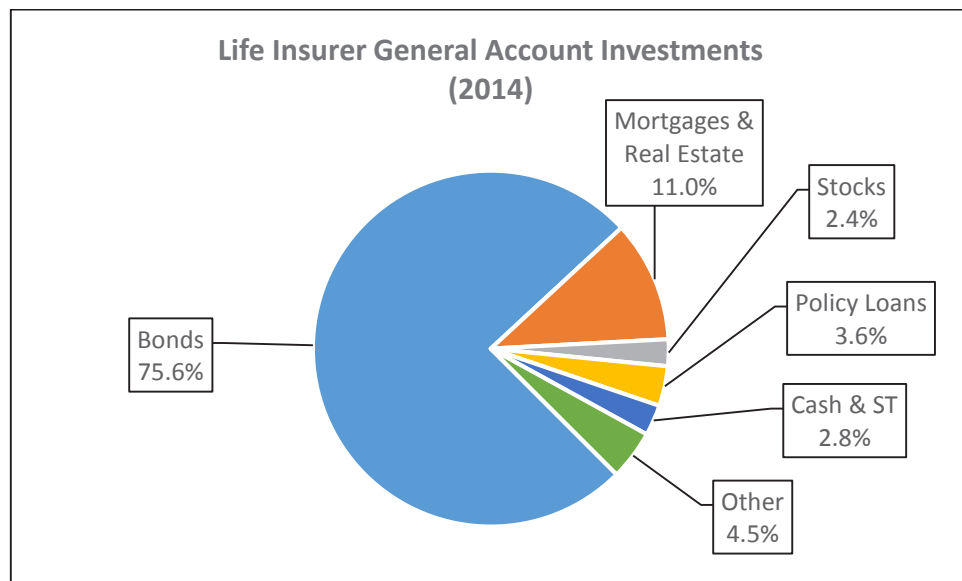
This M Intelligence piece is designed to contemplate this question by examining the fundamentals that drive UL crediting rate movements and establishing expectations going forward.

UL Crediting Rates Are Supported by Insurance Company Portfolio Yields, Which Lag New Money Rates

UL crediting rates are supported by insurance company portfolio yields. Insurance companies price UL products with a target interest spread (portfolio yield less crediting rate), which they maintain by changing the UL crediting rate (subject to the guaranteed minimum crediting rate) as the portfolio yield varies. For example, if the portfolio yield declines by 25 basis points (0.25%) then the UL crediting rate will also be reduced by 25 basis points and vice versa.

See Figure 1. More than 80% of insurance carrier asset portfolios consist of investment-grade bonds and mortgages.

Figure 1: Life Insurer General Account Investments



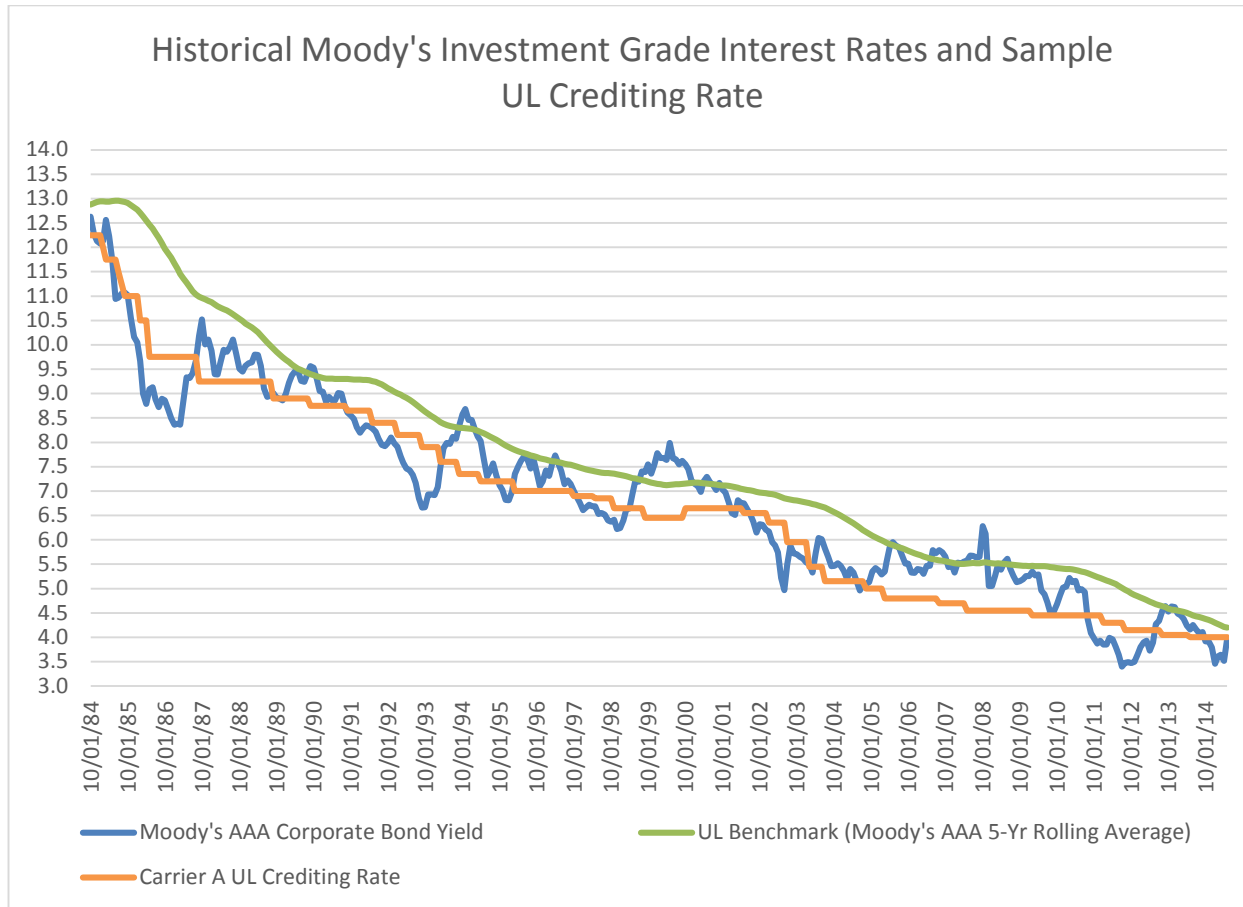
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December Fed Fund Rate Increase and Impact on Universal Life Crediting Rates (continued)

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 in order to maintain pricing interest margins.

See Figure 2. The Moody's Aaa Corporate Bond Yield, a new money rate, represents a typical insurance company investment and the 5-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 in the 12–13% range in the early 1980s and are now in the 4–5% range. Note the rolling average rate (i.e., proxy insurance company portfolio yield) chases the new money rate (i.e., corporate bond rate) and the strong correlation with the sample UL crediting rate movement.

Figure 2: Historical Interest Rates



Relationship Between the Fed Fund Rate and Corporate Bond Rates

As discussed earlier, insurance carriers primarily invest in corporate bonds and mortgages. Corporations can set their own bond rates, without directives from the Fed. In practice, however, a corporation that wants investors to buy its bonds sets a rate that is higher than the Fed target rate. There is no exact formula for this. The rate depends on the financial health of the company, plus the market's perception of what a fair bond rate would be in exchange for taking on the risk of buying the company's bonds.

Therefore, it will take time to see the resulting impact of the Fed fund rate increase on corporate bond rates.

In addition, the bond market is forward-looking, and because the Fed had all but confirmed the increase would happen by year end, the rate increase was priced into the market before the Fed made its announcement. Corporate bond rates have already increased approximately 90–100 bps in 2015, which demonstrates the forward-looking nature and the many different factors that impact bond rates (not just changes in the Fed fund rate).

UL Crediting Rate Projection

An estimated projection of changes to insurance carrier portfolio yields can be calculated by using a proxy portfolio yield benchmark. A proxy benchmark is 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 of assets insurance carriers have recently trended towards in an effort to pick up additional yield.

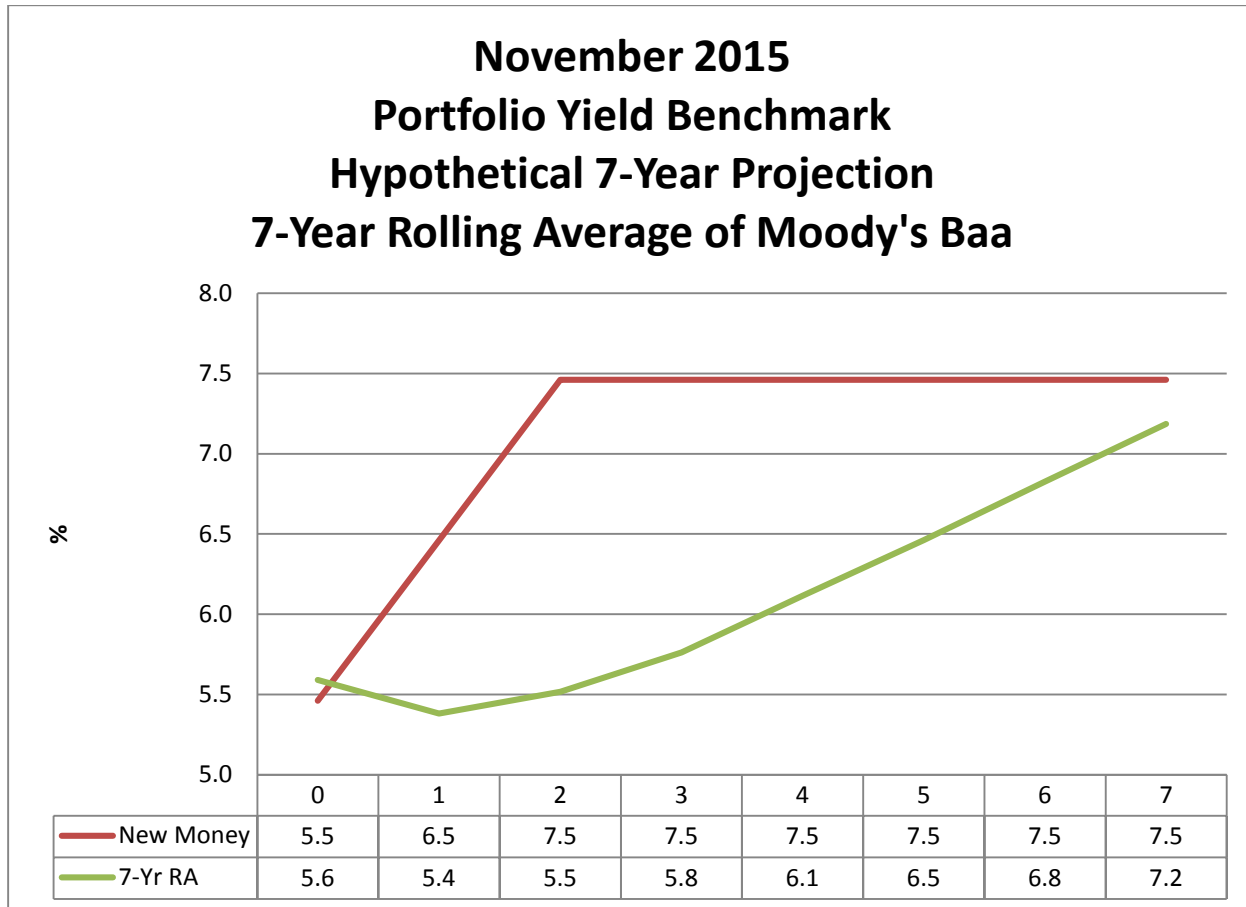
The projected portfolio yield benchmark is dependent upon an assumption for the direction in future new money rates (i.e., Moody’s Baa).

Fed officials made it clear, as noted in post-meeting documents, that the pace of Fed fund rate increases will be gradual and dependent on the quality of economic data. The Financial Times polled 51 top economists on how fast they think the Fed would raise rates in the next two years. The median projection is for the Fed to lift rates by 75 basis points in 2016 and a further 100 basis points in 2017.

For the projection, we will assume a similar scenario where new money corporate bond rates increase 100 bps per year over the next two years. This scenario is optimistic as bond rates are not directly tied to Fed fund rates and as bond rates had already reflected the anticipated Fed fund rate increase.

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

Figure 3: Insurance Carrier Hypothetical Portfolio Yield Benchmark Projection



December Fed Fund Rate Increase and Impact on Universal Life Crediting Rates (continued)

Conclusion

Following the Fed action, patience, while managing client expectations, is key. It is unlikely the Fed action will have an immediate positive impact on UL crediting rates.

While the Fed fund rate increase is welcome news and could eventually drive higher portfolio yields and UL crediting rates, the main takeaway is this: portfolio yields will most likely continue to decline over the short term (2–3 years) as portfolio yields lag new money rates and new money rates continue to be below portfolio yields (approximately 25–50 bps as of today).

Due Care practices for policy management and evaluation remain critical to successful client relationships, including ongoing policy reviews to assess actions to maintain financial goals and considering 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).

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