The HOTSPOT

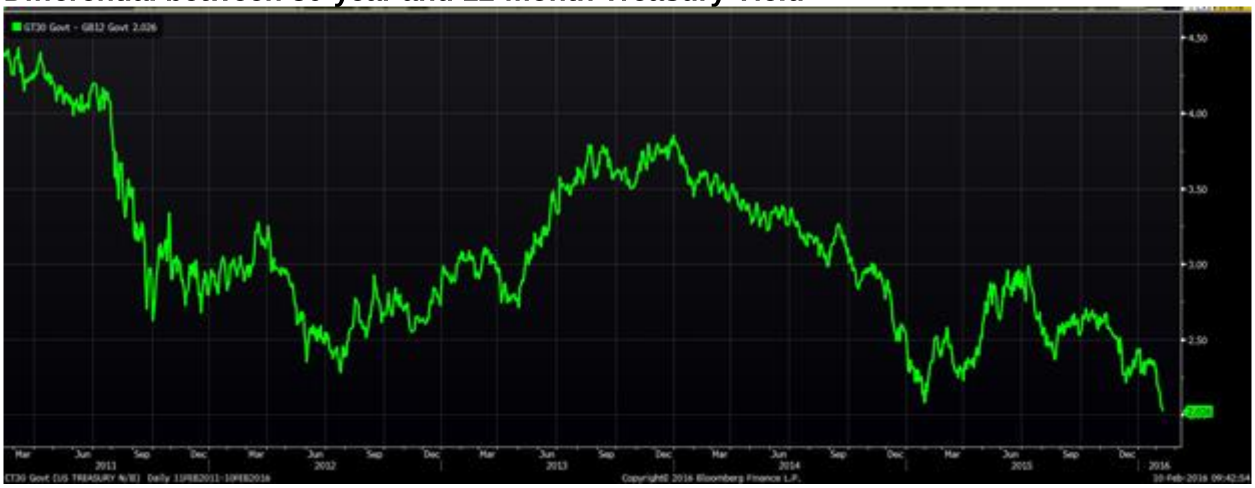
Complications for U.S. Insurers Caused by Flatter Yield Curve (02/10/2016)

Market volatility that began at the end of 2015 and increased significantly in the first few weeks of 2016 has led to a number of concerns for investors. More specific to the U.S. insurance industry is the retracing of long-term rates to lower levels, resulting in a flattening of the U.S. Treasury yield curve. In a testimony on Feb. 10, 2016, Federal Reserve Chair Janet Yellen combined a "steady-as-she-goes" account of Fed policy with an acknowledgement of intensifying risks. Virtual zero yields for ten-year government bonds in Japan and Germany that have, on occasion, drifted into negative territory are certain to weigh further on U.S. interest rates.

U.S. Treasury Yields (30-Year, 10-Year and 12-month)

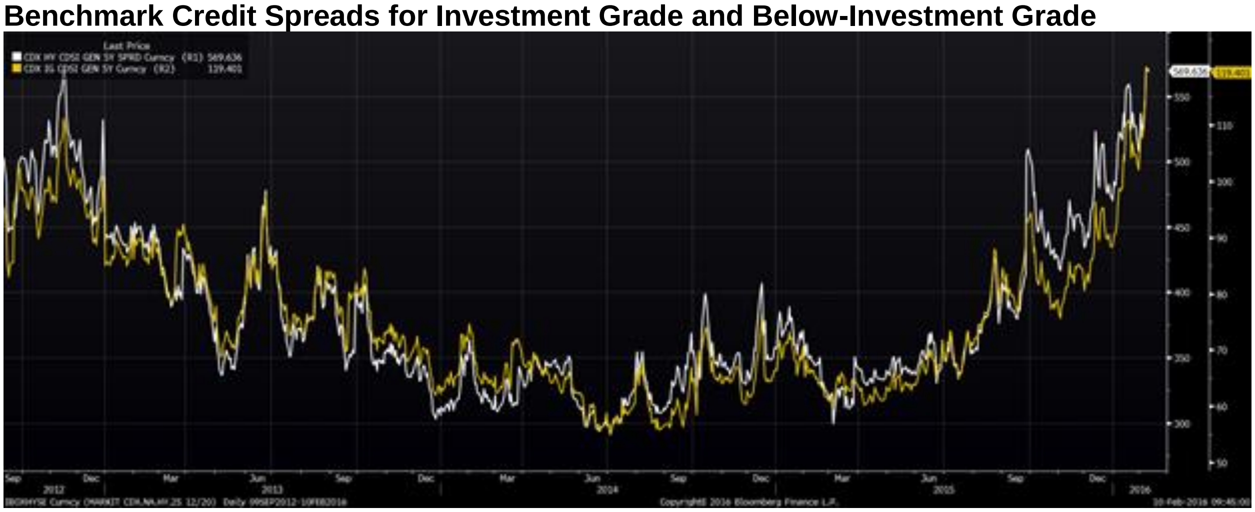
As of February 10th, the differential between the 30-year and 12-month U.S. Treasury yields narrowed to 202 basis points, its thinnest margin in the last five years. Financial institutions in general tend to achieve higher margins with higher interest rates as they typically improve the margin earned on their investment portfolios versus their costs, including payouts to investors, depositors and policyholders. Insurance companies usually benefit from steeper yield curves given their longer-dated liabilities.

Differential between 30-year and 12-month Treasury Yield



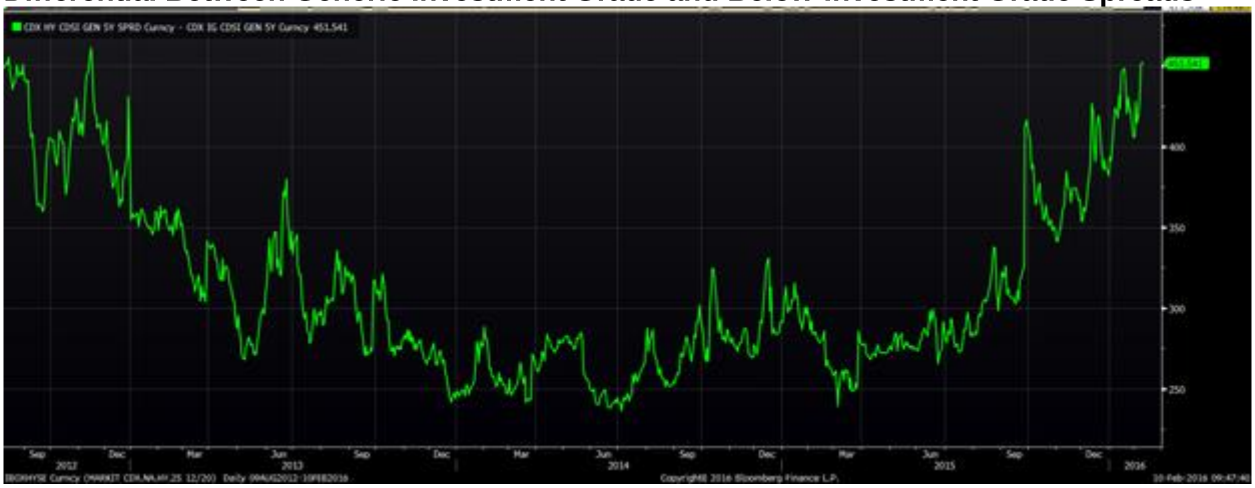
Meanwhile credit spreads—as measured generically between investment grade and below-investment grade markets—have shown similar volatility over the last six months. Current levels for investment grade and below-investment grade indices are at the highest levels since the end of 2012.

Benchmark Credit Spreads for Investment Grade and Below-Investment Grade



Notable is the differential between investment grade and below-investment grade spreads: at 451 basis points, it is the widest margin since the end of 2012. While credit concerns may be applicable to all corporate credits, the wider differential reflects a higher level of concern for weaker, more speculative credits. One driver of wider below-investment grade spreads is the weaker companies in the oil and gas sector. Oil prices, as measured by the West Texas Intermediate benchmark, have dropped more than 70% from their peak in 2011 and more than 50% from their more recent high in 2015. Exposure to below-investment grade investments by U.S. insurers increased slightly in 2014, and while 2015 annual statements have not yet been submitted, below-investment grade exposure is expected to have increased (modestly) again in 2015. Overall, we expect exposure remains modest relative to overall assets and historic peaks.

Differential Between Generic Investment Grade and Below-Investment Grade Spreads



Lower interest rates, particularly long-term interest rates, and a flatter yield curve have presented an investment challenge for U.S. insurers, narrowing the net margin between net portfolio yields and crediting rates. This dynamic moderated somewhat in late 2013 through early 2015, but has returned in recent months. With wider credit spreads on below-investment grade bonds, investors in general are at least getting paid more for taking on the additional risk. However, given the level of volatility in the economy, questions remain as to whether or not it is enough. Reflecting on the increased level of market value volatility, the vast majority of bond investments for U.S. insurers are held at amortized cost. The notable exception is for below-investment grade investments held by companies that do not maintain an Asset Valuation Reserve. This includes mainly property/ casualty companies that increased their exposure to below-investment grade debt from roughly 2% in 2010 to more than 4% based on the most recent reported data.

While U.S. insurers have managed reasonably well through the lower level of interest rates and flatter yield curves in the last five years, albeit with tighter margins and weaker earnings. The renewed market dynamic, along with an increased level of market volatility that will likely cause alternative investments to become less attractive, warrants further regulatory vigilance. The Capital Markets Bureau will continue to monitor these trends and report as deemed appropriate.