The HOT SPOT

Reaching for Yield with Structured or Esoteric Investments (8/7/2012)

In the current environment of a relatively flat yield curve and low interest rates — and with the expectation that low interest rates will persist at least through late 2014 — investors in general and insurance companies specifically may seek investing in assets that generate a higher yield than the more traditional, "plain vanilla" investments, such as corporate bonds or U.S. Treasuries. Alternatives that would add incremental yield, though sometimes only nominal, would be structured or esoteric investments. The concern with a structured or esoteric investment is not necessarily that the probability of default would be higher than that of a more traditional investment, but rather, that other key factors — such as loss given default, predictability of income streams, market value volatility, liquidity and counterparty risk — could negatively impact the investment and, therefore, the overall investment portfolio.

For example, in the case of residential mortgage-backed securities and commercial mortgage-backed securities, recent Capital Markets Special Reports have highlighted that some structures have significantly higher downside volatility in more conservative loss scenarios than the majority of the insurance industry's holdings. In addition, income streams might fluctuate dramatically for leveraged interest rate products; that is, bonds whose coupon is not only dependent on the performance of an economic or market variable such as the Consumer Price Index, the London Interbank Offered Rate (LIBOR) or the Standard & Poor's 500 Index, but which can also be leveraged to exaggerate volatility. In some structures, if the economic or market variable does not meet a specified target, no interest payment is due. So, although the repayment of principal is not directly affected, the income stream of the bond can vary dramatically from one period to another. Finally, with synthetic structured securities — which are created through a credit default swap or other derivative whereby the synthetic aspect allows the investor access to investments that might not otherwise be available — investors might incorrectly identify the investments' relevant risks, including counterparty risk, because of the complex structure of these investments. The complexity of the cash flows of some of these structures can often make it difficult for investors to fully understand the drivers behind cash flows. Synthetic structured securities, which include credit-linked and different kinds of equity-linked securities, have existed for quite some time but tend to be much more prevalent when there is limited new issuance.

Aside from the concerns discussed above, the market for highly structured and esoteric investments is not necessarily liquid. That is, they are not traded frequently, and their market prices are not always readily available. These investments, therefore, cannot be relied upon to support unexpected, short-term cash flow needs that would require the immediate sale of the securities. Although there does not appear to be significant exposure in the insurance industry of these securities, there is considerable discussion in the marketplace about developments in these areas. Therefore, the Capital Markets Bureau believes it is important for state insurance regulators to be aware of the potential risks that these types of investments might carry, particularly in high concentrations, and to be alert for significant investments by any one insurer.