What a Rising Interest Rate Environment Means for Life Insurance Companies

Description

Back in the summer of 2012, the 10-year Government of Canada rate hit a low of 1.6%. These days, the 10-year bond is yielding 2.69%. As I look at my mortgage, auto loan, and line of credit statements, I shudder at the thought of what my interest payments might look like if rates continue their rise.

But the fact is, over the past year, interest rates have risen far more than the experts were predicting and with the Bank of Canada continuously warning that "prolonged low interest rates pose an additional economic threat," we best ready ourselves for the storm.

There are some who *welcome* this change in the interest rate environment — namely, life insurance companies who have struggled with low rates for years now. With long bond yields on the rise, life insurance companies can finally begin to feel some optimism after a long and brutal stretch of low interest rates.

Why low rates are bad for life insurance companies
Life insurance assets are primarily financial in nature and are composed of primarily bonds and stocks. Liabilities mostly consist of obligations related to the policies sold to various individuals. These companies invest their revenues and cash flows and pay their obligations with the money made from these investments. Life insurance companies have high reinvestment risk, as they have high duration liabilities. So with declining interest rates, assets kept getting reinvested at lower and lower rates, which meant lower and lower profits.

In response to years of historically low interest rates, **Sun Life** (TSX: SLF) is executing a strategy of higher growth, higher returns on equity (ROE), and lower volatility. This means lowering equity sensitivity and lowering interest rate sensitivity.

To this end, Sun Life sold its U.S. annuities business and reduced equity exposure by 50% and interest sensitivity by 35%, according to analysts. While it has effectively limited its upside when yields recover, predictability and lower volatility makes for a more attractive risk/reward profile.

Rising yields have already been good for life insurers' bottom line
Rising interest rates mean that cash flows will be invested at higher yields, and so the reinvestment

risk turns positive. We have already seen the benefits of this environment in life insurers' results.

In its latest quarter, **Manulife Financial** (TSX: MFC) reported that core earnings, which excludes the impact of financial market movements, increased 1.7%. The company posted a profit versus loss last year and took a $234 million markets-related charge. To get a sense of interest rate sensitivity, the company said in its most recent quarterly report that every increase of 1% in interest rates across bond markets adds $300 million to earnings.

Over at Sun Life, core profit in the latest quarter increased 72% versus last year and the company now has $2.8 billion of cash, which it most likely will use to further strengthen the balance sheet by reducing debt.

Great West Life (TSX: GWO) reported earnings per share of $0.54, a 7% increase versus last year. And Great West has an ROE of 15.2%, higher than both Sun Life and Manulife.

Interest rate sensitivity
In an interesting study, DesJardins Securities tested the correlation of stock prices to interest rate changes. It found that all else being equal, for every 10-basis-point move in the 10-year bond yield, Manulife stock would move by 3.9%, Sun Life by 2.8%, and Great West by 1.5%.

The bottom line
Nobody wants to believe that the days of cheap credit are coming to an end because, frankly, we have all enjoyed the benefits. However, with the risk staring us in the face, it is wise to look for investments that will benefit from such an environment — such as life insurance companies.

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Karen Thomas does not own shares of any companies mentioned.

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2. TSX:MFC (Manulife Financial Corporation)
3. TSX:SLF (Sun Life Financial Inc.)

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