Interest Rates Hold Steady: Is This Bad News for Sun Life Financial Inc.?

Description

The financial sector received some bad, albeit not entirely unexpected, news this week—the Bank of Canada is holding overnight interest rates at a historically low 0.75%.

The Bank of Canada estimates that the Canadian economy saw zero growth during the first quarter due to weak oil prices, and although GDP growth is expected to resume later in the year as non-energy exports increase, bolstered by a weak Canadian dollar, many are now predicting Canada will not see a 2015 interest rate hike—even if the U.S. moves to increase them this year as anticipated.

Insurance companies like **Sun Life Financial Inc.** (TSX:SLF)(NYSE:SLF) are extremely sensitive to interest rates due to their large exposure to fixed-income investments. Assets, liabilities, and earnings can be all adversely affected by a period of interest rate weakness.

Is Sun Life prepared for a continued period of interest rate weakness? To find out, let's look at how interest rates affect insurance companies, and then at how Sun Life is exposed to these effects.

How insurance companies are affected by interest rates

Insurance companies largely have three sources of revenue– premiums, investment income, and fees. Insurance companies collect premiums in exchange for adopting various degrees of risk, and since claims on these premiums occur on an uncertain timetable, the companies will often invest the money in the interim in something known as the general fund.

This fund, in turn, generates income from interest and dividends, and this income is used in conjunction with premiums to generate an insurance company's earnings. The two often work together, and in times of high interest rates, insurance companies often decrease premiums, sometimes even pricing policies at an underwriting loss with the expectation that strong investment income will more than offset the loss.

The opposite is true for periods of low interest rates, but since companies are often limited to the degree in which they can raise premiums, low interest rates can have a serious impact on earnings.

In addition, insurance companies also have exposure to variable annuity and segregated funds products, which provide various income and benefits guarantees to policyholders over the course of the policies life, which can often be 20-30 years.

These policies are risky, since interest rates can fluctuate wildly over these time frames. And because insurance companies often invest the premiums for these policies in interest-bearing assets, low interest rates can make it difficult for insurance companies to pay guarantees, which weighs on capital and reserves.

Sun Life has made moves to protect against these risks

Fortunately, Sun Life has some of the best risk management practices in the Canadian insurance business. First, the company has been in the midst of a steady move away from the "spread-based" businesses (where earnings are dependent on interest rates) towards more stable, fee-based businesses by expanding its asset management segment.

In 2014 Sun Life earned $4.4 billion in fee income, up from $3.7 billion in 2013, and this increase is largely from Sun Life's MFS investment management firm, which represents the company's global asset management business, and is responsible for managing assets for investors through mutual funds. Fees from this area now represent 19% of earnings, providing solid diversification in revenue.

Total assets under management for Sun Life's asset management business were $511 billion in 2014, up 15% from 2013, and these assets collectively represent 69% of Sun Life's total assets. This is compared with only 23% for **Manulife Financial's** asset management segment, which demonstrates that Sun Life's risk profile is lower because most of its assets are devoted to the less volatile, and less interest rate-sensitive asset management business.

Sun Life also made the recent move to sell its $1.35 billion U.S. annuity business, which significantly reduces Sun Life's interest rate risk and frees the company from the type of risky guarantees to policyholders that can severely deplete capital, reserves, and earnings in weak capital market conditions.

The result? Sun Life now estimates a 0.5% decrease in interest rates (which would be extremely unlikely) would decrease net income by only 5%.

CATEGORY

1. Investing

TICKERS GLOBAL

1. TSX:SLF (Sun Life Financial Inc.)

Category

1. Investing

Date
2025/08/26
Date Created

2015/04/17
Author
amancini