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INSURANCE SOLUTIONS

# How Life Insurers Account for Realized Losses May Cause Unnecessary Pain

INSIGHTS

An accounting method long used by life insurers has come under pressure amid rising rates and wider credit spreads, potentially setting the life insurance industry up for large unrealized losses. But there may be a solution.


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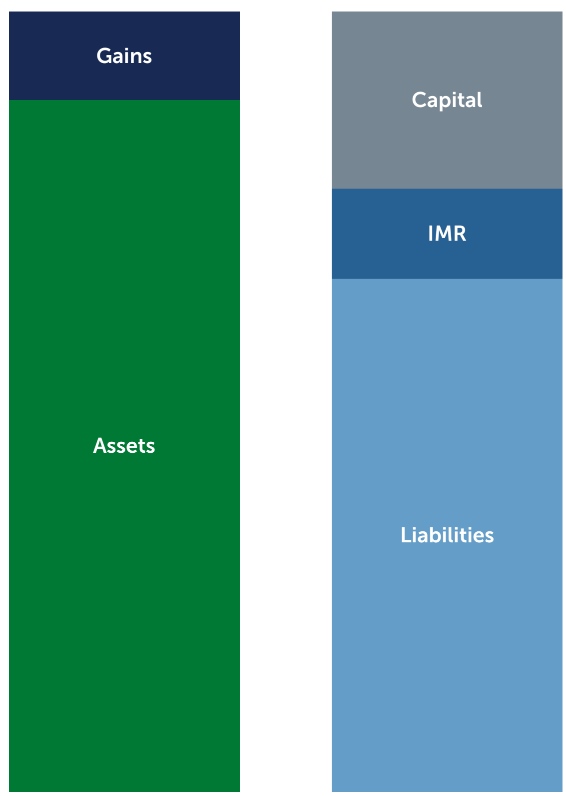
Life insurers have long used an Interest Maintenance Reserve (IMR) to adjust liabilities for unrealized gains and losses on the asset side of their balance sheets. This has worked well during periods of falling rates, resulting in increased gains. But with the recent double-whammy of rising rates and wider credit spreads, the mechanism is faltering. As IMR diverges from economic reality, it is time for it to be fixed.

## IMR has Worked Well Historically…

In the IMR, statutory accounting for life insurance captures realized gains and losses, net of tax. As the asset side of the book-valued balance sheet inflates due to gains taken, this reserve increases the liability side, effectively maintaining the current capital position of a company. The IMR amortizes over time at a pace dependent on the remaining maturity of the sold securities that created the gains, and this amortizing reduction in IMR ultimately becomes investment income. In this way, net investment income is largely immune to volatility driven by realized gains and losses.

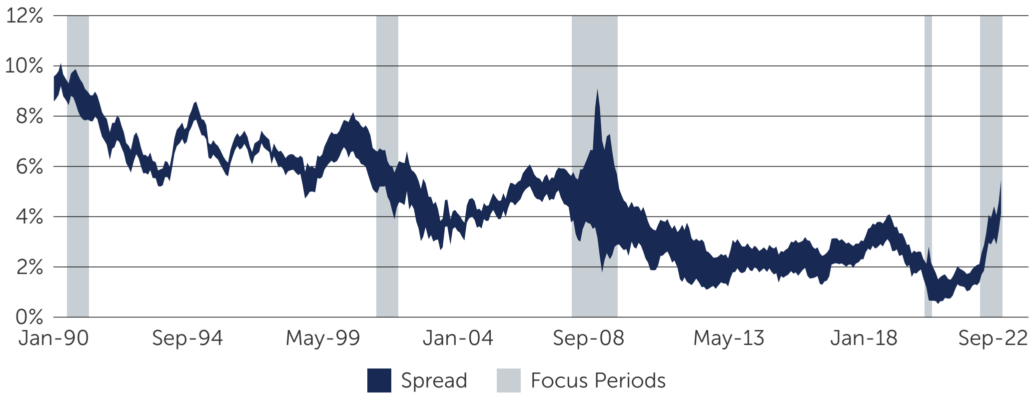
**Figure 1: IMR on the Balance Sheet**




Source: Barings.

IMR has worked well since its inception in 1992 as interest rates have generally fallen during this period, and fixed income investments have increased in value. Namely, unrealized gains for the industry have been robust, and portfolio trading has resulted in realized gains, replenishing levels of IMR that supplement investment income over time.

**Figure 2: Historic Spreads and Yields for Broad Market Single-A Corporates**

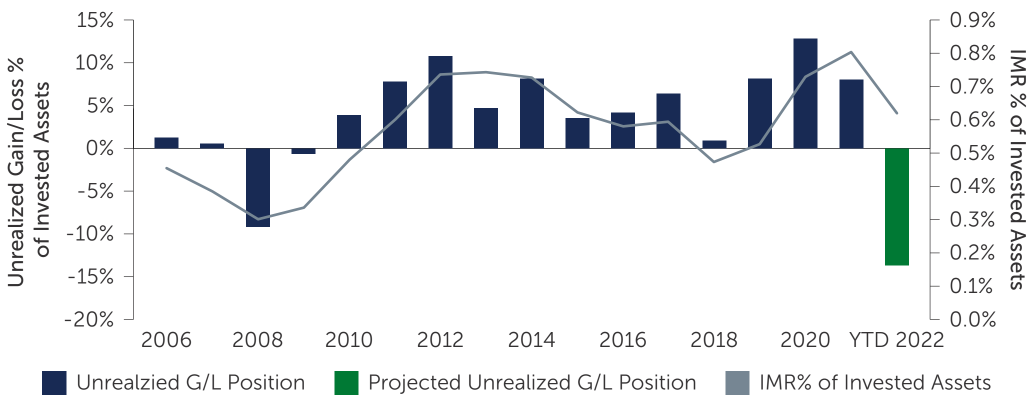



Source: Bloomberg. As of September 30, 2022.

## … But is Faltering Amid Rising Rates & Wider Credit Spreads

Recently however, amid decades-high inflation and contractionary monetary policy enacted by the U.S. Federal Reserve, interest rates and credit spreads have uncommonly risen together in dramatic fashion, swinging the life insurance industry's unrealized gain position to a large unrealized loss. The Corp A-rated index, a rough proxy for insurance bond portfolios, has fallen 17.9% in the first three quarters of 2022. This is the largest three-quarter drop recorded since index inception in 1998. Excluding the three quarters trailing Q2 2022 (-13.4%), the next largest drop was -11.6% during the Great Recession in 2008, as Treasury rates fell sharply and spreads widened considerably.[1]

**Figure 3: Industry Unrealized Gain/Loss Position and the IMR**

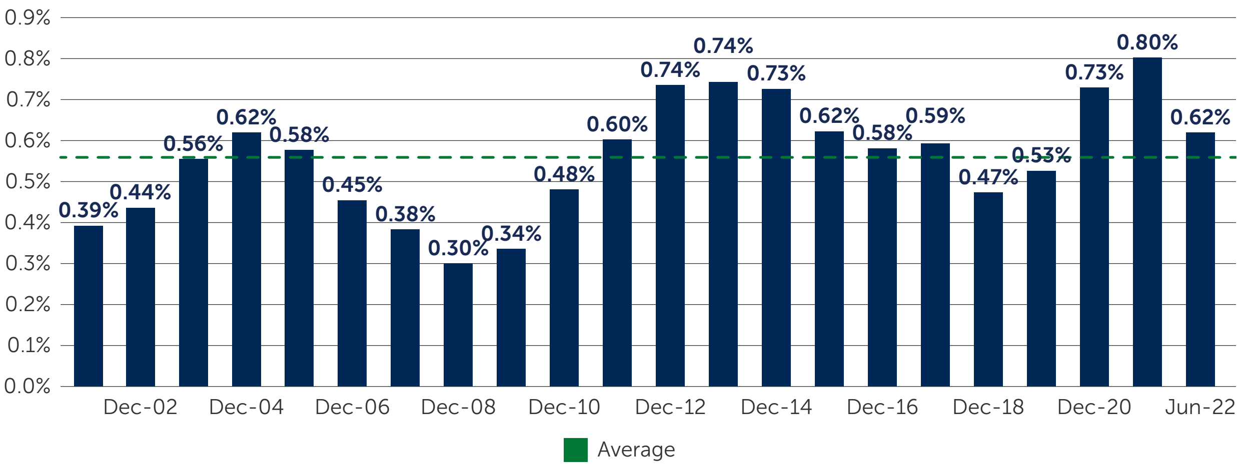



Source: S&P Global. As of June 30, 2022. Unrealized loss position is estimated as of 3Q22 using regression of historical unrealized gain/loss against market indices. IMR position is as of 2Q22.

1. Source: Bloomberg. As of September 30, 2022.

Further, any future portfolio trading will likely trigger realized losses. These losses will be absorbed by the IMR to the extent the losses are interest-rate driven, which will predominantly be the case. Though the current IMR position of the industry is modestly healthy at 0.62% of invested assets, IMR fell sharply by 22% in the first two quarters of 2022.[2] While the third-quarter IMR for the industry has not yet been released as of this writing, given the decline in portfolio market values, IMR will likely fall sharply again.

**Figure 4: IMR % of Cash and Invested Assets**




Source: S&P Global. As of June 30, 2022.

Over the last 15 years, annual portfolio turnover of sales and maturities in the industry has ranged from 17–32%, averaging around 23%.[3] Should this pace continue, given the severity of the estimated current unrealized loss position, IMR balances will come under pressure over the next year. Interest rate-related losses taken after IMR reaches zero will result in a direct reduction to capital, causing risk-based capital (RBC) ratios to drop. Historically, when IMR balances are low, trading becomes less frequent as companies seek to manage their realized losses, often to the detriment of credit risk management. Should credit downgrades accelerate as expected, insurers may have a difficult time repositioning the portfolio away from higher-risk assets as realized losses will burn through capital.

## A Potential Solution: Negative IMR

This capital depletion does not reflect economic reality. Under U.S. statutory accounting, benefit reserves do not ebb and flow with market rates as asset values change with rates. The IMR, which has acted as a buffer for the lack of market valuation of statutory reserves, has an arbitrary and unnecessary floor of zero on the balance sheet, which distorts the economic health of the industry during periods of rising rates, such as we are in today. We believe that allowing, also known as admitting, a negative IMR on the balance sheet would restore this functionality—just as realized gains are deferred into a reserve account—and allow insurers to avoid direct capital losses due to interest rate movements beyond their control.

2. Source: S&P Global. As of June 30, 2022.
3. Source: S&P Global. As of September 30, 2022.

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