

Terry Group A-Grade Corporate Bond Yield Curve for Valuing Long-Duration Insurance Contracts

The valuation of long-term insurance policy benefits is shifting to a current-market valuation basis, with effective dates in 2023 and 2025.

Current market discount rates are based on an “upper-medium grade” fixed income yield, which is broadly interpreted to mean A-grade corporate bonds.

In valuing future policy benefits, FASB rules further specify that insurers reflect the duration characteristics of the liabilities and use valuation rates that maximize reference to observable bond data.

Constructing an Appropriate A-Grade Bond Portfolio

Adhering to this standard entails an assessment of relevant bond yields across the full range of maturities. The most direct way to reflect market rates is to develop a complete yield curve from a portfolio of A-grade bonds, applying year-by-year rates developed from that curve to discount future policy benefits.

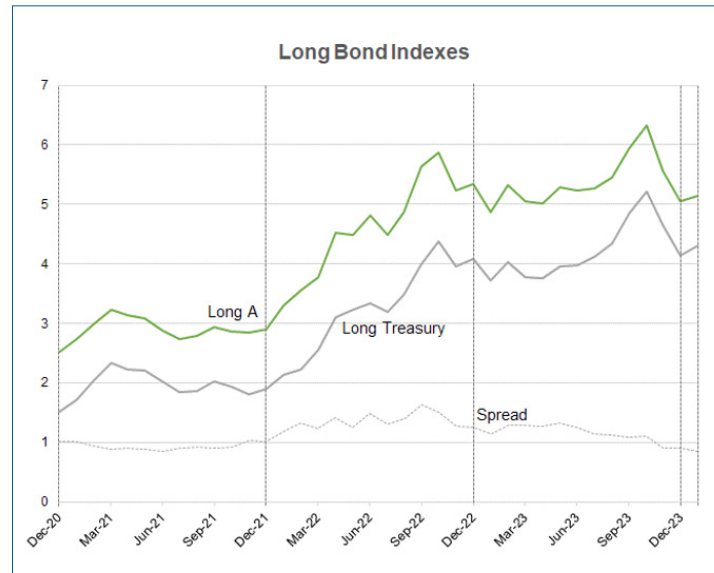
In constructing a curve from market data a number of technical and methodology considerations must be addressed, including:

- range of credit ratings by different rating agencies
- minimum issue size to ensure credible bond trading/pricing
- inclusion/exclusion/adjustments for bonds with call features and other embedded options
- inclusion/exclusion of private placement, quasi-government and less broadly-traded bonds
- relative quality/appropriateness of pricing sources and timing for end-of-day price measures
- potential curve-fitting approaches, with varying emphasis on tightness of data-fit vs. smoothness
- extrapolation of long-end rates, beyond the range of credible bond data (a critical factor since payments for many insurance products extend well past 30 years).

Ensuring acceptance by auditors requires that the yield curve be comprehensively documented, consistently applied, and provide results closely reflective of current capital markets and market changes across time.

Bond Market Update

Monitoring generally available market information such as bond index averages is necessary to ensure market consistency. Any variation in model vs. market results should be evaluated and rationalized.



	Corp A	Treasury	Spread
1/31/2024	5.15	4.30	0.85
12/31/2023	5.05	4.14	0.91
11/30/2023	5.56	4.66	0.90
10/31/2023	6.33	5.22	1.11
9/30/2023	5.94	4.85	1.09
8/31/2023	5.46	4.34	1.12
7/31/2023	5.27	4.13	1.14
6/30/2023	5.23	3.97	1.26
5/31/2023	5.28	3.95	1.33
4/30/2023	5.02	3.75	1.27
3/31/2023	5.06	3.77	1.29
2/28/2023	5.33	4.04	1.29
1/31/2023	4.87	3.72	1.15
12/31/2022	5.34	4.08	1.26
11/30/2022	5.23	3.96	1.27
10/31/2022	5.87	4.37	1.50
9/30/2022	5.63	4.00	1.63
8/31/2022	4.87	3.48	1.39
7/31/2022	4.49	3.19	1.30
6/30/2022	4.81	3.33	1.48
5/31/2022	4.48	3.23	1.25
4/30/2022	4.52	3.10	1.42
3/31/2022	3.78	2.55	1.23
2/28/2022	3.56	2.23	1.33
1/31/2022	3.31	2.14	1.17
12/31/2021	2.91	1.89	1.02

Sources: Bloomberg Barclays Long A US Corp, US Treasury Long Indexes

Long corporate yields have moved down roughly 120 basis points from their October peak, to levels last seen in the spring. Meanwhile, long Treasury yields have declined by only 90 basis points over that same period, thus driving the credit spread down from 111 basis points to 85. A reduced credit spread is generally indicative of increased confidence in capital markets, i.e., an improved outlook for the economy and higher equity pricing.

The fixed income environment over the past few years has been dominated by the shift in monetary policy aimed at dampening inflation expectations. Rate shifts during this period have been indicative of ever-changing perspectives about whether emerging inflation has been constrained, thus enabling a relaxation of the monetary policy restraint. Corporate rates are further impacted by cyclical vagaries in economic activity and the resulting demand for capital funds.

Building and Applying a Yield Curve

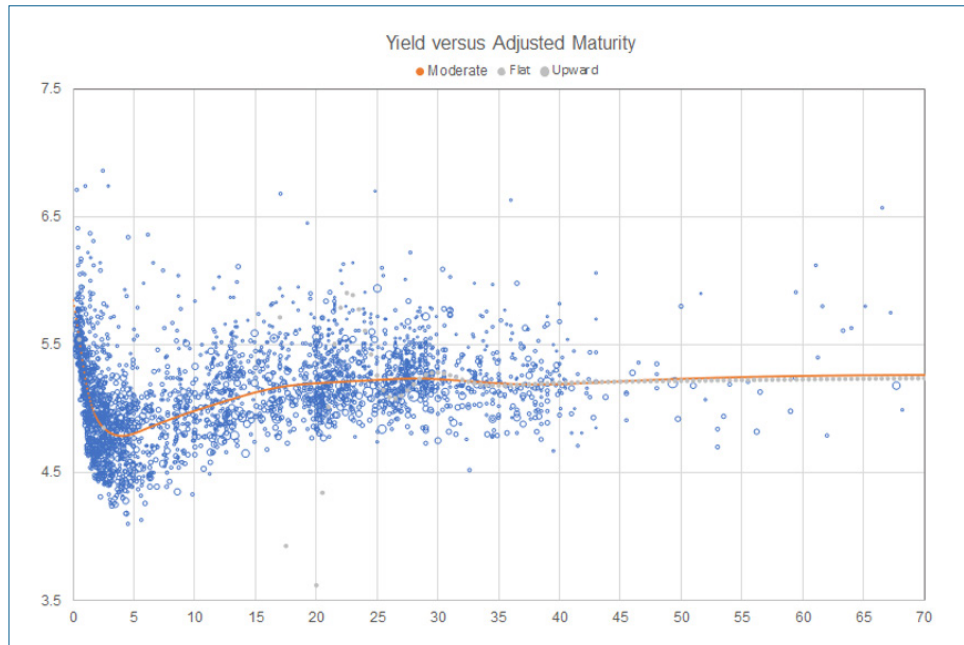
The following exhibits illustrate the results of an A-grade yield curve model developed as of January 31, 2024.

After filtering the A-grade bond universe for grading, optionality and other factors, the portfolio consists of about 3,000 bonds. These are arrayed across maturity groups; a curve is then fit to that array, with a goal of reflecting the mean/median yield for each maturity group. Note that two technical adjustments are made in the course of fitting the curve:

- The bonds are characterized, and maturity group averages determined, based on “adjusted” rather than nominal maturities. These adjustments are necessary since the fitted curve is based on a par bond assumption, while few bonds pay coupons

at current market rates.* Thus, bonds are reflected in curve-building at maturity points that align each bond's actual duration with that of a par bond.

- The fitted curve is modified to the extent necessary to ensure a relatively smooth pattern of yields, with these adjustments tightly controlled to ensure that the overall curve maintains an accurate representation of mean/median yield levels.

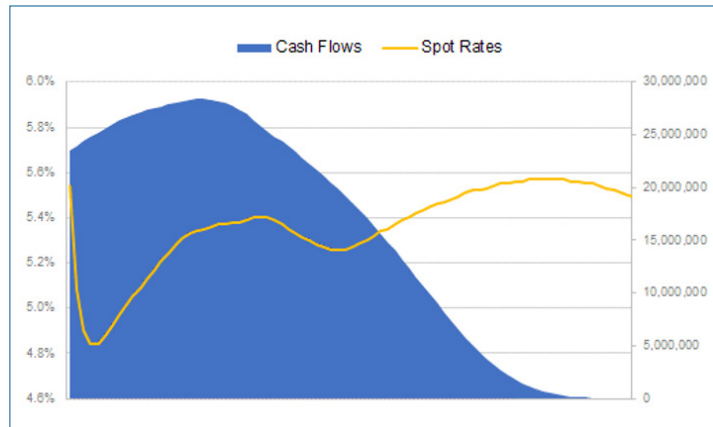


Bond data from Bloomberg

- Once yields have been determined at each maturity point, spot rates can be derived (based on a methodology termed “bootstrapping”). These spot rates are then applied to a given set of projected benefit cash flows, and a present value determined. Often, a flat/single equivalent discount rate consistent with that present value is calculated and used to represent the valuation result.

The example below reflects a very long duration cash flow (e.g., that for a deferred income annuity), along with the application of The Terry Group's moderate or baseline yield curve:

*Since the curve utilizes a par bond convention, representing a given long bond at the maturity point where its measured duration is consistent with that of a par bond (with coupons presumed paid based on the market yield) maintains the integrity of the yield curve. This adjustment becomes an especially critical issue when market rates vary significantly from historic levels. The longest maturity bonds in our portfolio have an average coupon of 4.2%, while January market yields average 1.0% higher. When yields are significantly higher than coupon rates, our model extends the bond maturities so that the (lower coupon) bonds' durations align with par bonds represented at these market rates. A typical bond in the longest maturity portion of the January portfolio is being extended by roughly 3 years.



Single Equiv Discount Rate	5.27%
Present Value (millions)	\$460.4
Duration	15.3

Variations in Discount Rate Outcomes

Discount rate outcomes almost always vary based on the duration of a given set of benefit cash flows—since the yield curve is almost never totally flat. Another element of variation in outcomes results from the approach taken to extrapolate the curve beyond the maturity point at which the most credible data ends—generally considered to be at about 30 years. The extrapolation impact will of course vary based on the duration of a given cash flow, i.e., for durations below 12 there will generally be little impact.

Given our adjusted maturity methodology and the high level of rates in recent periods, there has been a significant increase in the number of bonds placed above the 30-year maturity point. The Terry Group’s January portfolio includes roughly 440 bonds with adjusted maturities beyond 30 years, 100 of which have adjusted maturities beyond 40 years. This information enables a fairly robust curve build beyond the typical 30-year credibility boundary. The array of January yield curve results can be summarized as follows:

Jan 31, 2024	Extrapolated Slope		
	Flat	Moderate	Upward
Short	5.12	5.12	5.12
Long	5.25	5.25	5.25
Very Long	5.27	5.27	5.27

Note: the three sets of cash flows have durations ranging from 7 to 15.5.

January discount rate outcomes generally increased by 10–15 basis points, closely aligned with the shift in bond index results. But recent period discount rate results have indicated two rather atypical patterns that have significantly changed the nature of the curve build:

- The pattern of rate increases that began in early 2022 pushed market yields ahead of typical bond coupons; for the longest bonds average yields now exceed average coupons by about 100 basis points. This means that the typical bond at a given maturity point, with a coupon below the market yield, will have a longer duration than the par bonds represented on the curve at that maturity point. Thus, based

on our “adjusted maturity” approach, these bonds are represented as par bonds at longer maturities that align with each bond’s calculated duration. This results in a curve build that has become more credible at longer maturity points.

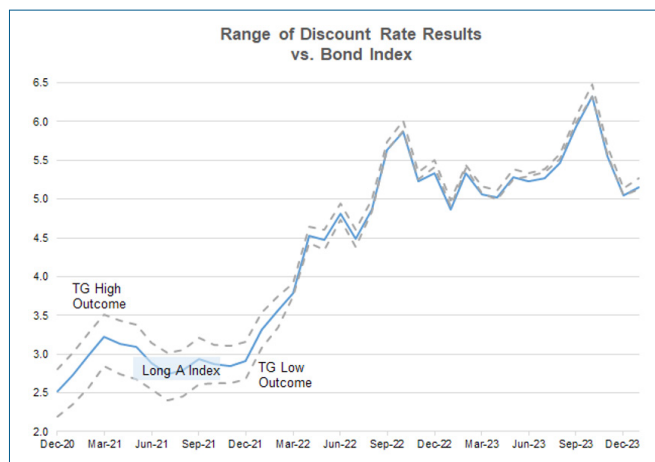
- Consistent with the recent month pattern, January yields are generally flat, even slightly declining after the 30-year maturity mark. This pattern essentially removes the possibility of rationalizing an extrapolated upward slope at the long end. The flat yield pattern likely indicates a market expectation that the recent high-rate period will not continue much longer. (In other words, whatever term premium would normally be expected is being outweighed by an expectation of declining yields.)

The summarized discount rate outcomes indicate that the variation in results based on duration is minimized—there is a range of only 15 basis points across our three sample cash flows for January, significantly below the typical dispersion across durations.

The variation in results based on the choice of extrapolation approach is completely eliminated given the flat yield pattern. In comparison, results from the December 2021 model (i.e., before the shift in monetary policy) showed variations up to 15 basis points.

Both sources of volatility—related to duration and curve-fitting impacts—should be expected to change significantly over time with evolving capital market conditions.

The following graph shows the range of Terry Group model results over the trailing three-year period. Before the monetary policy shift, the variations in discount rate outcomes for our sample cash flows—encompassing variations in both cash flow duration and model/slope—generally resulted in a range of about 50–60 basis points, roughly centered around the index average yield. As the graph illustrates, these relationships were significantly disrupted in early 2022 by the emergence of a flatter sloped curve pattern. The flatter yield pattern coincided with the initiation of the Federal Reserve’s monetary policy shift, i.e., rates increased much more at the short end (that the Fed directly controls) vs. the long end (that is more reflective of market expectations).



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