BULLETIN: MARCH 2023

LIFE INSURERS' EXPOSURE TO BANKING TURMOIL IS LIMITED

Three U.S. banks failed this month and were seized by regulators—Silvergate, a crypto bank, collapsed on March 8; Silicon Valley Bank (SVB), the central lender to Silicon Valley startups and a bank with $209 billion in assets, failed on March 10; and Signature Bank (SB), a New York-based bank with ties to real estate and the legal industry was seized on March 12. SVB and Signature were the second and third largest bank failures in U.S. history, ranking behind Washington Mutual which failed back in 2008. In addition, First Republic Bank (FRB) saw its stock fall more than 66% as concerns emerged the bank would not be able to handle a rush of withdrawal requests.

Member Firms, their policyholders, and our broader M Community are seeking answers to some important questions.

We have not seen this type of frenzied activity since the global financial crisis of 2008 and would first like to assure Member Firms, their policyholders, and the broader M Community that M is on solid footing with extremely limited direct exposure to the failed banks and FRB.

As a corporation, we bank with one of the top 10 major banks, which last week reiterated the strength of its financial position and liquidity, and has reduced its investment portfolio as a percentage of total assets from 30% to 25% over the last five quarters.

M Financial has two investment portfolios: our M Financial Holdings (MFH) portfolio that primarily supports our operations, and our M Life portfolio, which directly supports our reinsurance business and treaties. A large percentage of our MFH portfolio holdings are invested for the short term, particularly at this time of year as we pay out our annual dividend and Member Firm compensation.

We are regularly and actively in contact with our investment advisors and have been assured that M has no exposure to the failed banks, FRB, or Credit Suisse (CS) in our M Life portfolio. In addition, exposure to regional banks is less than 2% of our M Life portfolio. Our limited exposure to FRB in our MFH portfolio is within FDIC insured limits. The bank has recently been bolstered by a group of major banks and its insured deposits appear to be stabilizing. We are still evaluating any potential exposures in our alternative investments, but those represent less than 5% of our total consolidated M portfolio.

Separately, and stemming from a completely different issue, the Swiss government last weekend facilitated the corporate buyout of CS by its rival UBS at a price about 60% less than CS's market capitalization the previous Friday. CS is the first global bank designated as systemically important to be rescued since the financial crisis. The designation was driven by a series of scandals over several years, a change in top management, and multibillion dollar losses across several investment funds.

The banks that recently failed all had one thing in common—a large portion of their deposits were in long-term investments that lost value as the Federal Reserve pursued its policy of hiking interest rates. After many years of low interest rates, rapidly rising rates have created unrealized losses for banks which invested heavily in low yield, long-duration bonds during that time. Additionally, SVB has a concentrated focus on venture capital and startups, and recent economic and market conditions have been driving increased withdrawals and reduced deposits, forcing the crystallization of unrealized losses.

As we watch this transpire, one important thing remains clear: Life insurers are, and remain, structurally different from banks in several key aspects:

- First, life insurers do not have liquid liabilities, with the exception of fixed annuities, that can be surrendered on demand. Even policy loans typically have a provision that allows the carrier a six-month window with which to fund them. Similarly, 1035 policy exchanges into a different carrier's products take time to process. This is completely different than banks that are primarily funded by short-term deposits that can be withdrawn on very short notice. SVB saw its customers attempt to withdraw $42 billion in deposits in less than two days after it sold $21 billion in bonds at a loss and announced a $2 billion capital raise. SB lost 20% of its deposits, or $17.8 billion, in just one day. The events at SVB subsequently created liquidity pressure on some additional banks as customers sought to move money into institutions viewed as better capitalized.
- Second, when a bank "run" occurs, the institution sees its cash flow dry up and is forced to sell assets. By comparison, even during times of severe financial stress, life insurer policyholders continue to pay their premiums, thereby providing operating cash flow. New and recurring premium payments create a substantial revenue stream, and when policy cash values are dispersed due to a withdrawal, exchange, or surrender, it is not an instantaneous process. While transactions are usually processed much more quickly, insurers may take up to six months to process certain types of requests. This allows carriers the necessary time and financial flexibility to effectively weather the storm and avoid having to make any asset sales on a distressed basis. At no time was this more evident than during the 2008 financial crisis where despite the substantial market upheaval and government bailout of multiple banks, including the large money-center institutions, only three insurers required government assistance and, most importantly, not a single policy claim payment was missed.
- Third, while mark-to-market losses (or gains) on a bank's investment portfolio do matter because they may have to be sold on short notice, that is not the case for life insurers. Even though rising interest rates caused life insurers' bond portfolios to change from a roughly 8%-10% gain at year-end 2021 to a similarly sized unrealized loss at year-end 2022, the largely illiquid nature of policy liabilities means they can hold their investments to maturity and redeem them at par. As such, they are far better insulated from large scale liquidity events. Life insurers typically hold very conservative investment portfolios that are typically 70% investment grade bonds. Similarly, the approximate 10% held in commercial mortgages are also of high quality with loan-to-value levels typically in the 60%-65% range. By comparison, higher risk investments such as below investment grade bonds, equity and owned real estate collectively account for less than 10%, with policy loans and cash making up the balance.

The risks for life insurers lie more with their policy liabilities through actuarial assumptions and reserves for long-tailed exposures such as long-term care, no-lapse universal life, and indexed annuities with living benefits. Each of these products is highly complex and carries a multitude of embedded assumptions related to investment spreads. With mortality/morbidity, persistency/lapses, and expenses, any adverse experience is prone to play out over decades vs. the very sudden liquidity-triggered "run on the bank" experienced by Silvergate, SVB, and Signature. Still, it is important to understand the industry's exposure—and specifically our carriers' exposures—to financial services, regional banks, and commercial real estate. It is also important to understand other potential pressure coming on the funding side from higher lapses in products such as fixed annuities and fixed-indexed annuities.

According to statutory filings, life insurers generally have low exposure to regional banks and CS. At the top of the list is Lincoln Financial Group, with $729 million of exposure to the combined banks—18% of the company's market capitalization—including $156 million in SVB and FRB and $178 million of CS bonds. As a percentage of book value, exposures to regional banks and CS bonds are in the low- to mid-single digits for publicly traded life insurers. With respect to fixed income exposure to banks/finance/insurance companies, these were typically 20% of fixed income holdings based on amortized cost as of year-end 2022. However, the vast majority of those exposures are either with money center banks or other life insurers. Regional bank exposure is modest as a percentage of amortized cost.

However, should the bonds of these banks remain impaired for more than two consecutive quarters, we could see asset write downs at the insurers that have relatively higher exposure to these areas. There could also be the potential for ratings downgrades, although with more modest exposure, we consider this to be more unlikely for life insurers. Equally telling, to date the National Association of Insurance Commissioners has yet to comment on the current situation, suggesting to us that they do not see it as a material event at this point for life insurers. Nor have any of the rating agencies placed the industry on "credit watch." By comparison, shortly after SVB and SBNY were closed, Moody's Corporation placed six other banks on review for downgrade: First Republic Bank, INTRUST Financial Corporation, Western Alliance Bancorporation, Comerica Incorporated, UMB Financial Corporation, and Zions Bancorporation.

Life insurance is sold and serviced in a highly regulated environment with numerous protections for policyholders. Insurers must meet regulatory reserving requirements and are well capitalized with strong liquidity. Insurers also further mitigate risk and spread liabilities through the use of reinsurance and retrocession. Producers should employ best practices when managing in-force policies, such as conducting periodic reviews of policy performance and due diligence on insurers. Finally, state guarantee associations provide additional protections to policyholders in the event of a failed insurer, in a manner that is somewhat analogous to how the Federal Deposit Insurance Corp. provides protections to bank customers.

It is often in the client's best interest to maintain existing coverage, both because the underlying need for the coverage remains and surrender charges, age changes, and underwriting implications may offset any potential or perceived gains from surrendering or replacing existing coverage.

We will continue to monitor any further developments very closely and look forward to reaching back out to Member Firms and the M Community in the coming weeks with a more detailed look at the life insurance industry and life insurers' investment portfolios.

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