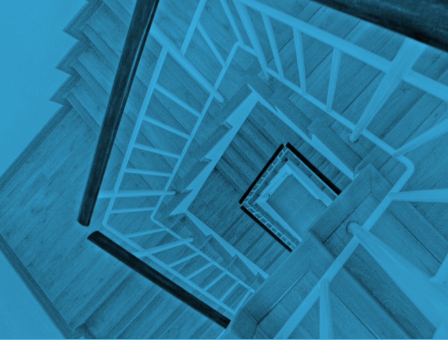

NEAM VANTAGE POINT

Perspectives

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OUR VIEW ON INSURANCE CAPITAL MANAGEMENT TOPICS

IN THIS ISSUE ►

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Fraternal Investment Portfolios: Walking a Different Path

Fraternal insurers play a niche and important role within the life insurance space. As non-profit, member-owned organizations, fraternal companies operate differently from other life insurers. How do the investment portfolios of fraternal insurers support their unique operations and status?

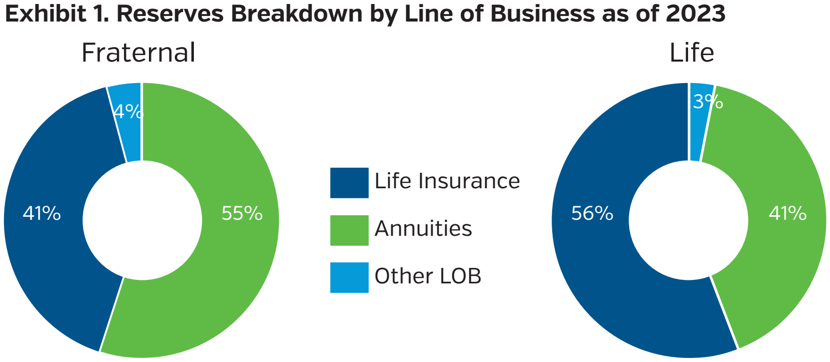
EXECUTIVE SUMMARY

In this issue, we examine the enterprise profile and investment characteristics of U.S. fraternal insurers, drawing comparisons with the broader U.S. life insurance industry. Despite being generally smaller in size, fraternal insurers have recorded comparable investment income (expressed as a percentage of invested assets) with the broader industry over the past four years. However, the fraternal composite's fixed income portfolio book yield has been lower compared to the life industry, and the gap between the two groups has widened since interest rates began to rise in 2022. While the fraternal composite's fixed income credit quality was in line with the rest of the life industry, duration and sector allocation differences may have been contributing drivers to the lag in book yields.

SCOPE OF ANALYSIS

We use a composite of 66 fraternal companies[1] that were operating as of year-end 2023. This fraternal composite is compared to a U.S. life industry composite of 320 firms that underwrite life insurance, annuities, or other lines of business (including accident and health), excluding those in the fraternal composite.[2] As seen in Exhibit 1, the fraternal composite had a higher concentration in annuities than in life insurance compared to the rest of the life industry.

Exhibit 1. Reserves Breakdown by Line of Business as of 2023



Source: S&P Capital IQ Pro

FRATERNAL COMPOSITE'S ENTERPRISE PROFILE

Lower Investment Leverage Compared to the Life Industry

Table 1 compares the statutory surplus, total invested assets, and loss reserves between the fraternal composite and the life industry over the past three years. As of year-end 2023, the fraternal composite had a lower level of investment leverage (invested assets-to-surplus ratio) compared to the life industry, likely due to being more annuity-focused than life-focused.[3] When comparing the distribution of invested assets, fraternal companies tended to be smaller in size than the rest of the life industry. The fraternal composite experienced greater growth in surplus over the past three years, while the life industry's invested assets and reserves grew more during the same period.

Table 1. Surplus, Invested Assets, Premium, and Reserves Trend in 2020-2023

Composite	Item	2023	2022	2021	2020	2023 Growth	3-Year CAGR*
Fraternal Composite	Surplus ($B)	23.8	23.1	22.9	19.1	3.1%	7.7%
	Invested Assets ($B)	162.8	159.0	157.2	152.8	2.4%	2.1%
	Company # (% of total #)	66	68	68	68		
	Invested Assets > $2B	*7 (10%)*	*7 (10%)*	*7 (10%)*	*7 (10%)*		
	$500M < Invested Assets < $2B	*13 (20%)*	*13 (19%)*	*13 (19%)*	*10 (15%)*		
	Invested Assets < $500M	*46 (70%)*	*48 (71%)*	*48 (71%)*	*51 (75%)*		
	Total Policy Reserves ($B)	113.2	110.7	108.4	109.1	2.3%	1.2%
	Invested Assets-to-Surplus	6.8x	6.9x	6.9x	8.0x		
	Reserves-to-Surplus	4.8x	4.8x	4.7x	5.7x		
Life Industry (Excluding Fraternal)	Surplus ($B)	489.0	466.3	476.5	440.9	4.9%	3.5%
	Invested Assets ($B)	5,184.6	5,035.8	4,886.2	4,655.9	3.0%	3.7%
	Company # (% of total #)	320	319	317	314		
	Invested Assets > $2B	*116 (36%)*	*112 (35%)*	*114 (36%)*	*110 (35%)*		
	$500M < Invested Assets < $2B	*43 (14%)*	*45 (14%)*	*42 (13%)*	*46 (15%)*		
	Invested Assets < $500M	*161 (50%)*	*162 (51%)*	*161 (51%)*	*158 (50%)*		
	Total Policy Reserves ($B)	3,459.2	3,425.9	3,317.1	3,245.9	1.0%	2.1%
	Invested Assets-to-Surplus	10.6x	10.8x	10.3x	10.6x		
	Reserves-to-Surplus	7.1x	7.3x	7.0x	7.4x		

Source: NEAM, S&P Capital IQ Pro

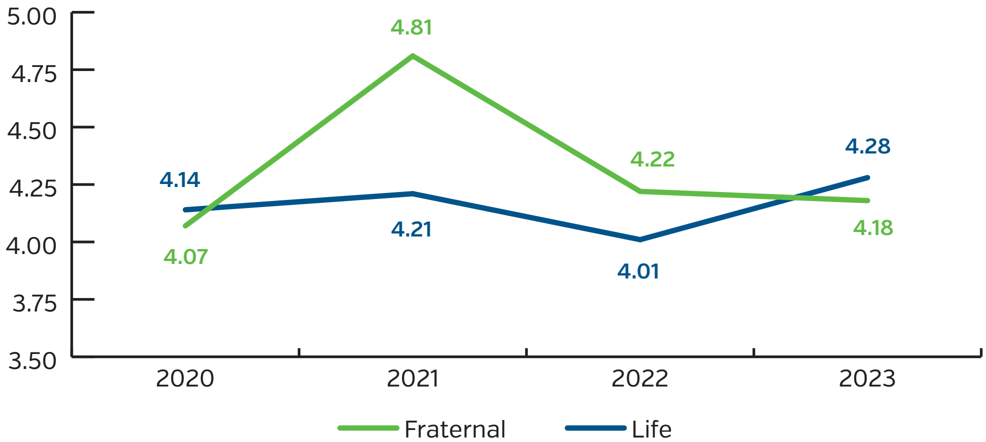
** Compound Annual Growth Rate*

A LOOK AT THE FRATERNAL COMPOSITE'S ASSET CHARACTERISTICS

Net Investment Income (%) Comparable to the Life Industry

Exhibit 2 displays the net investment income (as a percentage of total invested assets) of the fraternal composite and the life industry. Except for 2021, when the fraternal composite experienced unusually high gains from Schedule BA assets, net investment incomes were comparable between the two groups. The elevated contribution from Schedule BA assets lingered until 2022, boosting the fraternal composite's net investment income above that of the life industry. In 2023, the fraternal composite's net investment income was slightly lower than that of the life industry, similar to 2020.

Exhibit 2. Comparison of Net Investment Income (%) 2020-2023



Source: NEAM, S&P Capital IQ Pro

Table 2 displays the contribution to earned investment income from broad asset sectors. Combined, bonds and mortgage loans contributed nearly 80% of the total in 2023, while unaffiliated equities added a mere 2%. As mentioned earlier, Schedule BA's contribution peaked at 26% in 2021 and regressed to 11% in 2023, a level similar to that of 2020. In contrast, the contribution from bonds, which dropped to 59% in 2021, rebounded to nearly 70% in 2023.

Table 2. Earned Investment Income Contribution by Sector 2020-2023

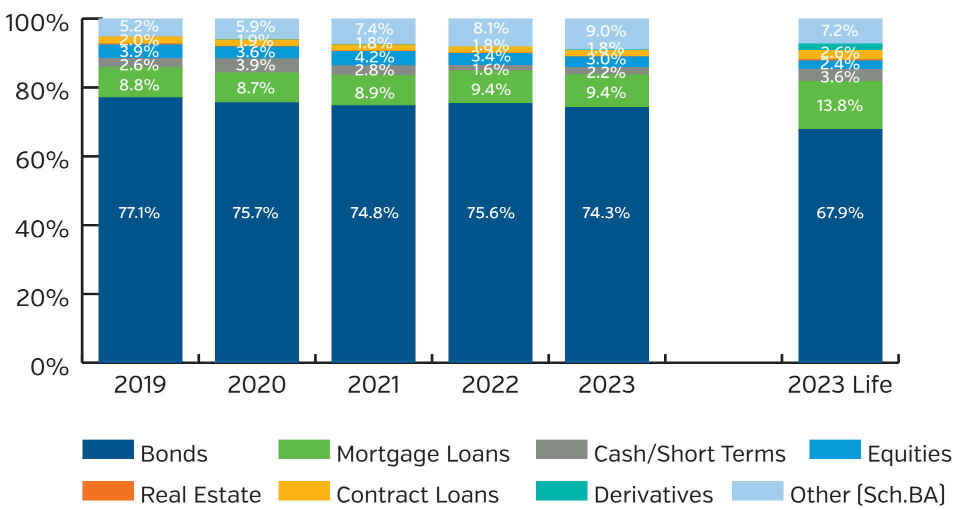
Asset Sector	2023 Life	2023	2022	2021	2020
Bonds	65%	69%	65%	59%	72%
Mortgage Loans	14%	9%	9%	8%	10%
Unaffiliated Equities	1%	2%	2%	2%	2%
Affiliated Bonds/Equities	4%	4%	4%	2%	2%
Cash/Short-Terms	3%	2%	1%	0%	0%
Real Estate	1%	1%	1%	1%	1%
Contract Loans	3%	2%	2%	2%	3%
Derivatives	-3%	0%	0%	0%	0%
Other (Sch. BA)	11%	11%	16%	26%	10%

Source: NEAM, S&P Capital IQ Pro

More Allocations to Fixed Income and Less to Mortgage Loans

Exhibit 3 illustrates the asset allocations of the fraternal composite and the life industry. The fraternal composite consistently favored bonds over other asset classes, but allocations have decreased since 2019. In contrast, Schedule BA assets have shown a notable increase from 5.2% in 2019 to 9.0% in 2023. Compared to the rest of the life industry, the fraternal composite was overweight bonds, Schedule BA assets, and equities and underweight mortgage loans and contract loans as of year-end 2023.

Exhibit 3. Invested Assets Sector Composition 2019-2023

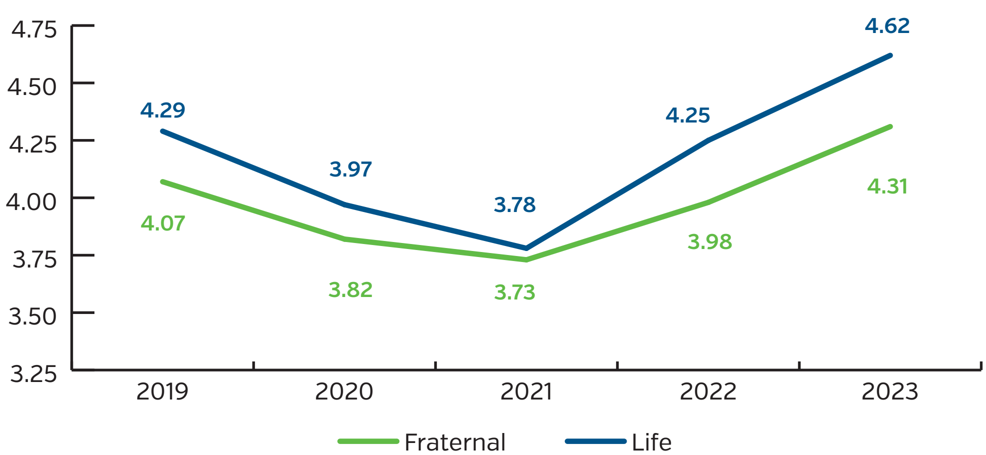


Source: NEAM, S&P Capital IQ Pro

Book Yield Trailing the Life Industry

As illustrated in Exhibit 4, the fraternal composite's fixed income portfolio book yield has been lower than the life industry's over the past five years. The once-narrow gap began to widen in 2022, reaching 31 basis points (bps) by year-end 2023. While the life industry gained an 84 bps increase in book yield since 2021, the fraternal composite's increase was 58 bps over the same period. We will investigate drivers of this discrepancy next.

Exhibit 4. Comparison of Fixed Income Portfolio Book Yield 2019-2023



Source: NEAM, S&P Capital IQ Pro

Table 3 illustrates the fraternal composite's fixed income book yields by sector and compares them with the life industry. The fraternal composite's book yield experienced a 33 bps increase in 2023, driven by sectors like asset-backed securities (ABS) and residential mortgage-backed securities – agency (RMBS – Agcy), whose book yields increased by 159 bps and 58 bps, respectively. The life industry has outperformed the fraternal composite, with higher book yields in all fixed income sectors except for commercial mortgage-backed securities – agency (CMBS – Agcy) and tax-exempt municipal bonds, of which allocations were not material. Notably, the fraternal composite's lower book yields from private placements and ABS were key factors in its lagging book yield compared to the life industry.

Table 3. Fixed Income Book Yield by Sector (%) 2019-2023

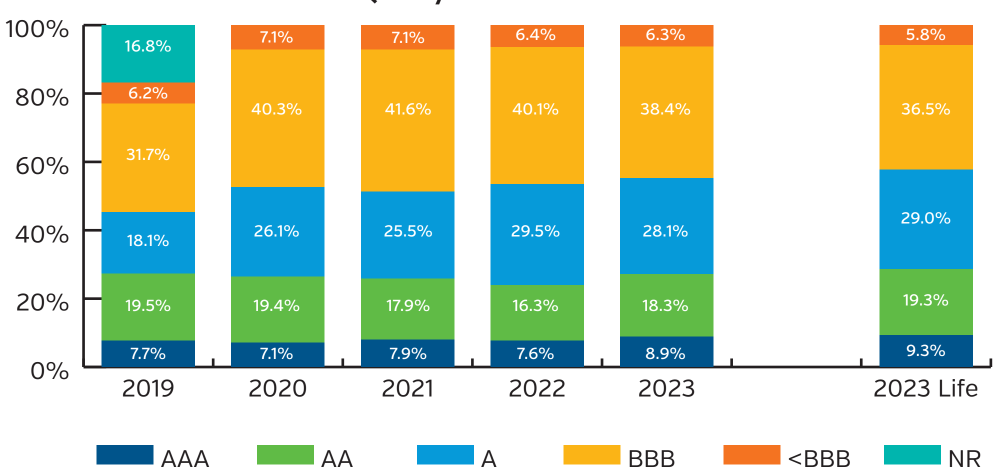
Fixed Income Sector	2023 Life	2023	2022	2021	2020	2019
Gov't/Agcy	3.38	2.88	2.41	2.35	2.21	2.79
Corp	4.40	4.37	4.18	4.01	4.17	4.31
ABS	6.44	5.69	4.10	2.96	3.29	3.91
RMBS - Agcy	3.72	3.54	2.96	2.62	2.48	3.24
RMBS - Non Agcy	5.49	4.71	4.25	4.26	5.36	4.83
CMBS - Agcy	3.29	4.29	3.86	3.51	3.53	3.50
CMBS - Non Agcy	4.55	3.87	3.55	3.13	3.23	3.37
Munis - Taxable	4.27	4.00	3.92	3.91	4.20	4.59
Munis - Tax Exempt	3.85	3.87	3.88	4.14	4.06	4.34
Privates	4.69	4.15	3.91	3.87	3.97	4.06
Foreign	4.62	3.65	3.51	3.37	3.44	3.71
Grand Total	**4.62**	**4.31**	**3.98**	**3.73**	**3.82**	**4.07**

Source: NEAM, S&P Capital IQ Pro

Similar Credit Quality to the Life Industry

Exhibit 5 displays the trends in credit quality of fixed income portfolios for the fraternal composite and the life industry.[4] Over the past five years, the fraternal composite has reduced its allocations to below investment grade (<BBB) bonds and increased its holdings in AAA-rated bonds. The rising interest rate cycle from spring 2022 through year-end 2023 elevated market yields including those for high quality bonds, reducing the appeal of risk-adjusted returns of lower quality assets. As of year-end 2023, the credit quality distribution of the fraternal composite was largely consistent with that of the life industry.

Exhibit 5. Fixed Income Credit Quality Distribution 2019-2023



Source: NEAM, S&P Capital IQ Pro

Duration Shorter than the Life Industry

Table 4 illustrates the option-adjusted duration (OAD) of the fraternal composite's and life industry's fixed income portfolios. In 2020 and 2021, the fraternal composite saw an increase in its OAD, which corresponds to the Federal Reserve's accommodative policy. In 2022, the fraternal composite OAD showed a slight decline as the interest rates began to rise. This trend continued in 2023, with OAD shortening across most sectors. Compared to the life industry, overall OAD for the fraternal composite was nearly one year shorter in 2023, with more pronounced differences in sectors such as tax-exempt municipal bonds and government bonds. This difference in OAD may also be driven by the fraternal composite's higher concentration in annuities compared to the life industry.

Table 4. Fixed Income Portfolio OAD by Sector 2019-2023

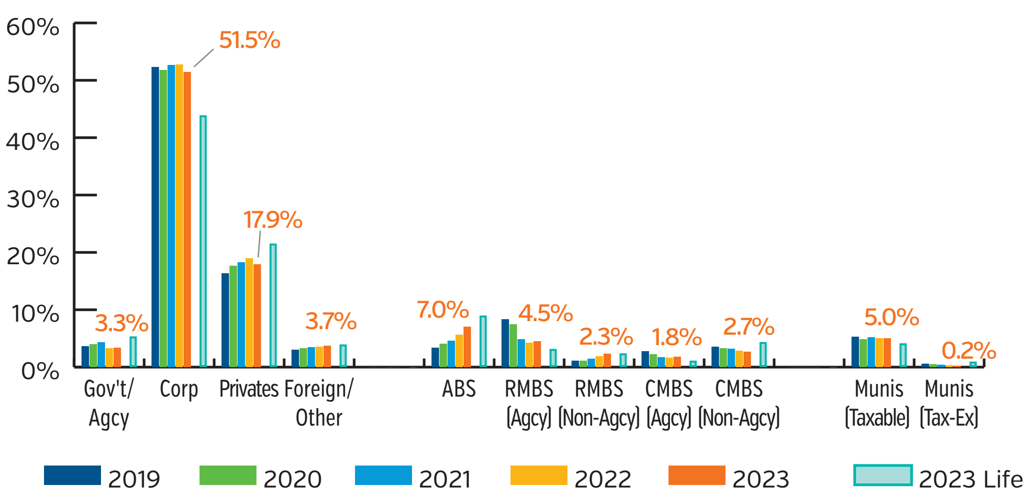
Fixed Income Sector	2023 Life	2023	2022	2021	2020	2019
Gov't/Agcy	11.5	8.5	8.3	6.3	6.3	7.1
Corp	8.5	7.1	7.2	7.6	7.2	7.0
ABS	3.1	3.4	3.9	3.4	3.1	3.4
RMBS - Agcy	6.4	5.9	6.6	5.1	4.5	4.6
RMBS - Non Agcy	5.3	6.9	6.7	3.8	3.2	4.6
CMBS - Agcy	4.7	3.7	3.6	3.9	4.7	5.7
CMBS - Non Agcy	3.3	3.6	3.9	4.0	4.1	4.4
Munis - Taxable	9.3	9.1	9.1	8.4	8.1	5.5
Munis - Tax Exempt	10.8	7.7	7.7	4.5	6.4	6.3
Foreign	6.9	6.7	7.0	7.6	6.4	5.7
Grand Total	**7.6**	**6.7**	**6.9**	**7.0**	**6.5**	**6.3**

Source: NEAM, S&P Capital IQ Pro

Overweight Corporates and Underweight Privates

The fixed income sector allocations for the fraternal composite and the life industry are shown in Exhibit 6. Since 2019, the fraternal composite has steadily increased its allocations to ABS, while it decreased allocations to RMBS - Agency. Compared to the life industry, the fraternal composite was overweight corporate bonds and underweight private placements.

Exhibit 6. Fixed Income Sector Allocations 2019-2023



Source: NEAM, S&P Capital IQ Pro

KEY TAKEAWAYS

We used a composite of fraternal insurers to represent their overall enterprise profile and compared that with the rest of the U.S. life industry to explore differences in their investment decisions. Some key takeaways from this analysis:

- Compared to the rest of the life industry, fraternal companies are generally smaller in size with lower investment leverage and have experienced higher surplus growth over the past three years.
- Despite individual companies being generally smaller in size, the fraternal segment's net investment income (%) was comparable to the rest of the life industry, except in 2021 when the contribution from Schedule BA assets was unusually high.
- Fraternal companies allocated more to bonds and Schedule BA assets, and less to mortgage loans compared to the rest of the life industry.
- Since 2019, the fraternal segment lagged the life industry in fixed income book yield:
    - While the fraternal segment and the rest of the life industry had similar fixed income credit quality, the fraternal segment had a shorter duration.
    - Compared to the rest of the life industry, the fraternal segment was overweight corporate bonds and underweight private placements.

ENDNOTES

[1] Companies whose NAIC filer types are "fraternal."

[2] All exhibits use statutory filing data as of December 31, 2023, from S&P Capital IQ Pro, supplemented by data from sources such as NEAM Analytics, Bloomberg, and ICE BofA.

[3] For more information on difference between life-focused and annuity-focused companies, please see the prior issue of NEAM Perspectives - "Life Insurance Industry's Net Investment Spreads: Who Suffers the Least?"

[4] Starting from 2020, the NAIC credit rating reporting expanded from six to 20 categories. The NR category shown for 2019 consists mostly of true private placement securities.

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