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Clarifying the bond ETF discussion for insurance investing

Bond ETFs are increasingly popular tools for insurers looking for exposure to fixed income without worrying about fluctuations in market liquidity. Recent NAIC accounting guidance could make bond ETFs even more attractive to insurers, since it gives them greater clarity over how to treat the instruments.

Executive Summary

Over the last six years, some significant regulatory changes have spurred insurance companies' interest in investing in exchange-traded funds (ETFs) that track bonds. The most recent of these occurred in April 2017, when the National Association of Insurance Commissioners (NAIC) issued accounting guidance providing additional clarity around how insurers could treat some of these ETFs like ordinary bonds.

Bond ETFs have a number of advantages over ordinary bonds. Among them are their resistance to short-term fluctuations in liquidity and potentially lower volatility during financial crises than cash bonds often exhibit. They are also useful for quickly taking exposure to different sectors of the fixed income markets, such as high yield, and can therefore be used to park capital while portfolio managers identify and secure appropriate cash bonds.

Because of these advantages, insurance companies have been allocating more capital to bond ETFs in recent years. In 2016, bond ETF assets held by insurance companies rose 25 percent from previous year. While the absolute figures remain small relative to total industry assets, the rate of growth is notable.

Background

The dynamics of the fixed income markets have changed since the financial crisis. Financial regulation has curbed proprietary trading and has imposed higher capital charges on traditional fixed income liquidity providers (i.e., investment banks). As a result, investors have gravitated toward alternative products for fixed income exposure that are more reliably liquid, in particular, ETFs.

Meanwhile, there has recently been a significant regulatory change that has bolstered insurers' confidence in these instruments. An example is the decision by the NAIC's Securities Valuation Office (SVO) to allow some bond ETFs to be treated as bonds, subject to certain conditions. And, over the last half-decade, a large number of bond ETFs have been reviewed by the SVO and included on its designated list of ETFs.

These developments have helped to foster the increase in insurers' use of these instruments. During 2016, for example, total industry holdings went up from about $15.2 billion to $19 billion. While those are certainly large numbers, these instruments still comprise a very small percentage of the industry's $5 trillion in total assets.*

The dominant users of ETFs continue to be property casualty companies. They accounted for about 60 percent of the total industry allocation to ETFs, with life insurance companies following up with about 30 percent and health insurers holding the balance.*

Equity ETFs made up 83 percent of the industry's total ETF assets in 2015, but that percentage declined in 2016 to about 75 percent due to the increased allocation to fixed income ETFs. While bond ETFs were 16 percent of the total at year-end, the proportion has risen to about 23 percent as of year-end 2016.*

Contributors
— Mike Earley, Head of Client Solutions—Americas
— Luke Oliver, Head of ETF Capital Markets—Americas
— David Stack, ETF Capital Markets

*Source: SNL Financial based on Dec. 2016 data.

Note: Unlike bonds, exchange-traded funds (ETFs) are subject to greater market risks, including the risk of loss of capital as bonds typically offer the repayment of principal, subject to the creditworthiness of the underlying issuer.

Accounting Clarity

The latest rule changes to benefit insurers looking to invest in bond ETFs provided accounting clarity. The NAIC's Statutory Accounting Principles Working Group approved substantive amendments to SSAP 26R - Bonds during the NAIC's spring meeting. The amendments were part of reference project 2013-36, which:

— Clarified that while ETFs and mutual funds generally do not meet the definition of bonds, certain bond mutual funds and ETFs can be accounted for under SSAP 26R in a manner similar to bonds;
— Provided specific ETF and fund guidance;
— Ruled that ETFs and funds are either reported at fair value (or net asset value if practicable), or at "systemic" value (a complex methodology based on cash flows). This is in contrast to direct bond holdings, which are recorded at amortized cost;
— Added or updated the nomenclature. It provides more clarity as to how insurers account for bond ETFs and funds that meet the SVO's description, offering insurers greater certainty over accounting when they invest in bond ETFs and funds.

These changes were welcome, although hurdles still remain in some states. Our clients use bond ETFs to achieve a variety of goals. Some state codes make it a challenge to construct portfolios entirely out of fixed income ETFs, but we have seen companies use them extensively in jurisdictions with sufficiently permissible state codes. In fact, one company replaced its entire bond portfolio with bond ETFs in order to achieve the exposures it wanted. However, that's a highly unusual case, and generally state code limits make that approach somewhat challenging.

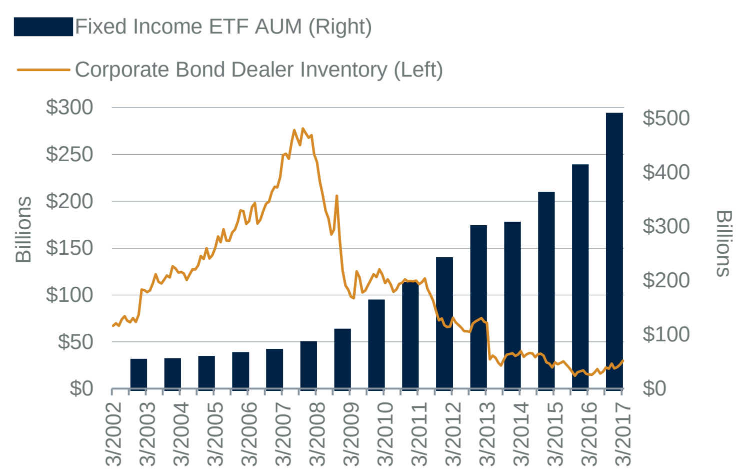
Short of that, insurance companies are using bond ETFs either to gain exposure to specific sectors, such as high yield, and using ETFs as placeholders to park funds as they work to secure other investments. For example, if a company wants to build or grow an investment grade corporate bond portfolio, and if it has a sudden, large cash flow, it might use a corporate bond ETF as a placeholder while it looks for the cash securities it wants to meet its portfolio needs.

Liquidity Access

The growth of fixed income ETFs has been remarkable with the first one launched in 2002, almost 10 years after the first equity ETF. By the end of 2006, there were only six products totaling $20.5 billion in assets. In 2007, the SEC approved the requirements for standardized Fixed Income baskets and the generic listing process for fixed income ETFs. Due to these changes, the industry saw an influx of new fixed income ETFs come to market from multiple ETF issuers. This was an opportune timing for what was about to happen next.

During the financial crisis in 2008, broker-dealers pulled back from their cash bond market-making businesses to conserve capital, shed assets and subsequently meet more stringent regulatory capital requirements. These changes reduced inventory of cash bonds, resulting in investors gravitating to alternative products; they discovered ETFs as a way to access the fixed income market. Currently there are 323 fixed income ETFs listed in the US with under $528 billion under management (March 2017). Figure one shows how ETF volumes grew as dealer inventories shrank; primary dealer balances are on the left axis and ETF assets under management since 2002 to March of this year on the right.

Figure One: Primary dealer inventory balances vs. ETF Fixed Income AUM



Source: New York Federal Reserve Bank and Bloomberg, as of March 31, 2017.Past performance does not guarantee future results.

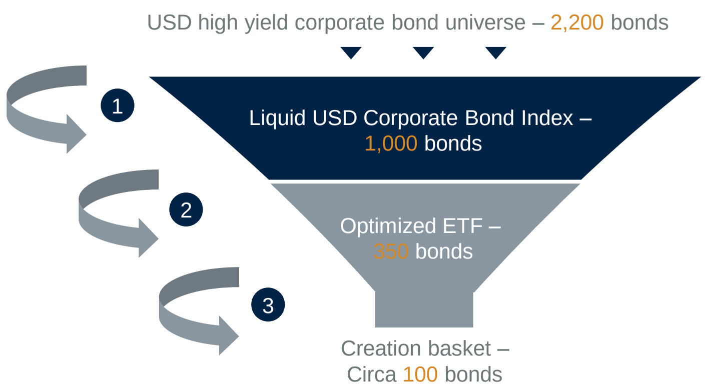
Bond ETF Mechanics

ETFs work via a creation/redemption mechanism that allows authorized participants (APs) to manage how a fund expands or contracts as a result of investor demand. In a creation, the AP delivers either cash equities or cash bonds to the fund. In return, the asset manager delivers ETF shares to the AP. In a redemption, the AP delivers ETF shares in exchange for cash equities or cash bonds. Only APs can create or redeem directly with the ETF trust. The key point here is that there are actual, physical securities changing hands.

The creation process for equity ETFs is usually full replication. So, for an S&P 500 ETF, there would be 500 equities delivered for creation or for redemption. Nonetheless, there are differences between equity ETFs and bond ETFs. Fixed income indexes can be much larger and bonds do not trade as continuously as equities.

Figure two shows how bond ETF portfolios can be constructed. The U.S. high yield corporate bond universe could contain about 2,200 bonds. The liquid U.S. corporate bond index for an ETF could include 1,000 of these bonds, but the ETF is optimized to include only 350. To create or redeem depending on what bonds are available could only require 100 bonds for delivery. Those 100 bonds would be chosen to be a good representation of the index to track the underlying portfolio.

Figure Two: Fixed Income ETF creation

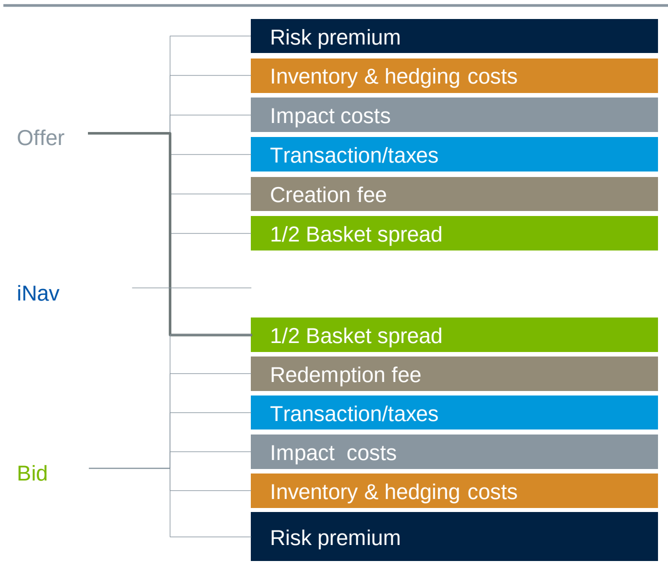


Source: Deutsche Asset Management 1Q2017. For Illustrative purposes only

Bond ETF Spreads

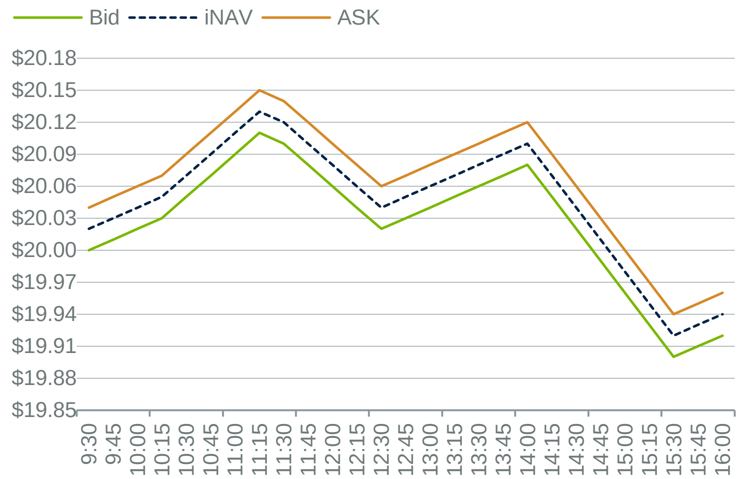
The spreads on equity ETFs are different from those on fixed income ETFs. Figure three shows how an equity ETF onscreen spread reflects the creation and redemption costs. Every ETF has a creation fee. These can range from a few hundred to a few thousand dollars. APs or market makers must pay any transaction fee and applicable taxes when executing the basket of underlying securities.

Figure Three: Equity ETF spread transparency



Hypothetical example of market pricing. For Illustrative purposes only.

ETF spread

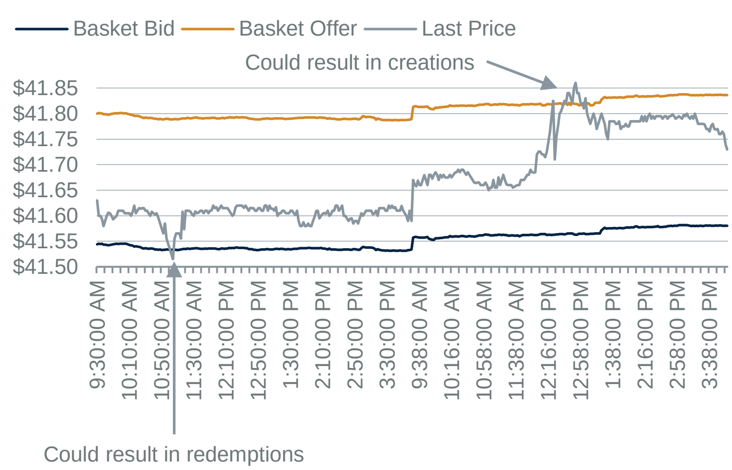


Hypothetical example of market pricing. Illustrative purposes only

Impact costs on the underlying securities depending on the size of the trade. Authorized participants or market makers are charged to use their firms' balance sheets. If they hedge, there is a cost to that, as well as a risk premium. These are all components of the spread in an ETF.

Fixed income is slightly different. Figure four shows the basket bid for a portfolio of bonds (blue) and a basket offer (orange). Since the NAV of fixed income ETFs is either marked to the bid or mid of the underlying cash bonds, fixed income ETFs will generally trade at a premium to reflect the full cost of creation/redemption.

Figure Four: Fixed Income ETF spread transparency



Hypothetical example of market pricing. For Illustrative purposes only.

Debunking ETF Myths

There are four concerns about bond ETFs that are often voiced that have little basis in fact. Putting these myths to rest is important so that insurers considering bond ETFs can make decisions based on the instruments' merits.

The first is that ETFs trade less during market corrections. In reality, what often happens is that volumes actually pick up two to three times their average daily volume. Since 2002, any time there has been an event or deep market volatility, we have actually seen the volume in the secondary market pick up.

The second concern is that high yield ETFs are moving the markets. In fact, high yield ETFs only represent approximately 4 percent of the high yield cash market (June 2017). Mutual funds make up almost 28 percent. It is important to keep that in perspective. If you think back to December 2015, when the high yield market was under some stress, there were a few mutual funds that had to suspend redemptions. ETFs had no such problem and continued to trade on the secondary market. There were no issues with the creation/redemption processes.

The third concern is that fixed income ETFs are constrained by underlying liquidity. That this is false can be seen every year on Columbus Day, when the equity markets are open but bond markets are closed. Fixed income ETFs trade on the equity exchanges, and on Columbus Day, they trade hundreds of millions of dollars very efficiently. Rather than being constrained by the underlying liquidity, they are additive to that liquidity profile.

The fourth concern is that fixed income ETFs do not have enough cash to meet redemptions. However, fixed income ETFs don’t actually have to have cash to meet redemptions, because they transact in kind, delivering cash bonds rather than cash. Unlike an open ended mutual fund, an ETF manager does not have to sell bonds to raise cash.

With these concerns allayed, insurance companies can focus on determining whether bond ETFs make sense as part of their portfolio strategies, and what degree of latitude their state regulators provide for their use. Given the changes to the traditional cash bond market since the financial crisis, bond ETFs can be useful tools for acquiring fixed income exposures that would otherwise be difficult to achieve.

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