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Municipal bond investment strategies for Life companies

At the end of December 2017, U.S. President Donald Trump signed into law the “Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018,” more commonly known as the Tax Cuts and Jobs Act. Among its provisions are several directly relevant to how the life insurance industry invests, including one aspect of the legislation affecting the “proration” of tax-preferenced income for life insurance companies, in particular tax-preferenced municipal bond income.

Background

U.S. taxation of life insurance companies has long taken the view that a portion of investment income earned by life insurers is used to fund reserves and policyholder benefits that in turn receive tax benefits. Accordingly, any tax-preferenced income needs to be allocated (prorated) between income attributable to policyholder funds (which does not receive a tax preference) and income attributable to the company (the “company share,” which does receive a tax preference). In the past, the proration was done according to a complex calculation that varied between companies, potentially over time, and generally attributed a large amount of the income to policyholders. The consequence was tax-preferenced municipal bond income was generally not economically competitive with taxable bond income for life companies.

The change

The change enacted in the recent tax law was to replace the proration calculation with a flat proration of 30% policyholder, 70% company share. The consequence is that life companies will enjoy a tax preference on 70% of the tax-preferenced income they receive. This includes not only tax-preferenced municipal bond income, but also any dividend received deduction (DRD) on common stock dividends. For tax-preferenced municipal bond income, this means for each $1.00 of income, taxes of 21% will be paid on $0.30 of that income, for an effective rate of 6.3%. This brings the effective rate for life companies much closer to the 5.25% effective rate for property/casualty companies.

The impact

The value of earning tax-preferenced income is only relative to what can be earned from similar taxable income. The relative value is dependent on the relative tax advantage coupled with the relative yield levels. Both alternatives have to be evaluated on an after-tax basis to reach a sound economic conclusion. In addition to after tax yields, other factors weigh on the analysis as well, such as long bond scarcity and correlation benefits.

Yields

The analysis to determine relative value between taxable and tax-preferenced is straightforward. At a high level, it’s the function of comparing the after-tax yield on like quality and like duration bonds. There is some complexity that needs to be factored in however. On quality, studies have shown actual default rates for municipal bonds historically are lower than their corporate bond counterparts. Regarding duration, the majority of municipal bonds contain call provisions that affect duration and convexity and need to be taken into consideration. This analysis is done on a crossover basis, looking at the relative value of each option as the next dollar is invested.

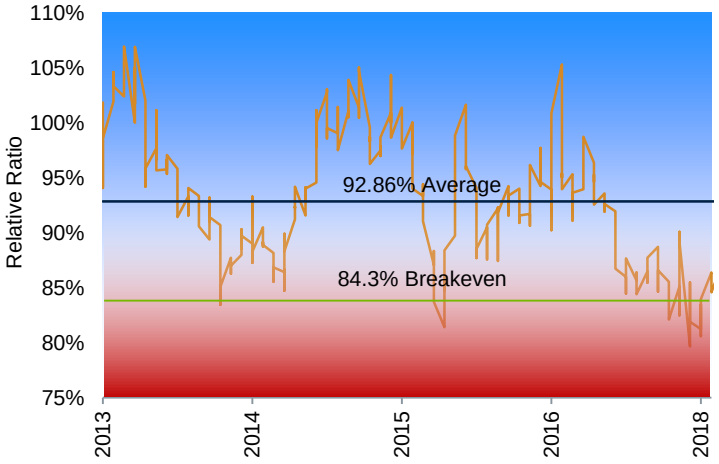
The ongoing nature of this analysis means the relative value fluctuates over time. This is particularly important for life insurers investing in the current environment. Generally, the after-tax income on a municipal bond (at 6.3% tax rate) is equivalent to the after tax income on a taxable bond (at 21% tax rate) as long as the pre-tax municipal bond yield is 84.3% of the pre-tax taxable bond yield.

The breakeven ratio is calculated as follows:

$$\frac{(1 - \text{Regular tax rate of } 21\%)}{(1 - \text{Muni tax rate of } 6.3\%, \text{ or } 21\% * 30\%)}$$

Anything higher than that puts the municipal bond at an advantage. This muni bond ratio is a common metric in municipal bond investing. The below chart shows how that ratio has changed over time for the ten year tenor of bonds, looking at AAA-rated general obligation bonds relative to U.S. Treasurys:

Relative Yield Ratios 10-Year AAA GO yield vs. 10Y U.S. Treasury yield



BLUE = Municipals provide after-tax advantage

RED = Taxables provide after-tax advantage

Period
As of April 30, 2018
Sources: Thomson Reuters AAA MMD Tax Exempt 10-yearr GO yield, Bloomberg 10-year Treasury yield

It is worth noting that municipal/Treasury yield ratios are not the same across the maturity spectrum. As an illustration, at the end of April 2018, a comparable set of ratios of municipal bonds (proxied using Municipal Market Data (MMD) AAA benchmark yields) to U.S. Treasuries was::

	MMD	UST	Ratio	5yr Avg
2yr	1.87	2.49	75.1%	86.2%
5yr	2.19	2.80	78.2%	79.8%
10yr	2.49	2.95	84.4%	92.9%
20yr	2.96	3.02	98.0%	105.9%
30yr	3.09	3.12	99.0%	101.4%

Longer dated bonds generally enjoy a greater advantage (or less disadvantage) relative to shorter maturity bonds due to retail investor preference for shorter duration (seven years and in) bonds. Direct retail holdings of municipal bonds make up 41% of the market. The choice of which bonds you compare in a crossover analysis in terms of credit rating and duration is more art than science, as bond default rates for municipal bonds tend to be lower than those of similarly rated corporate bonds.

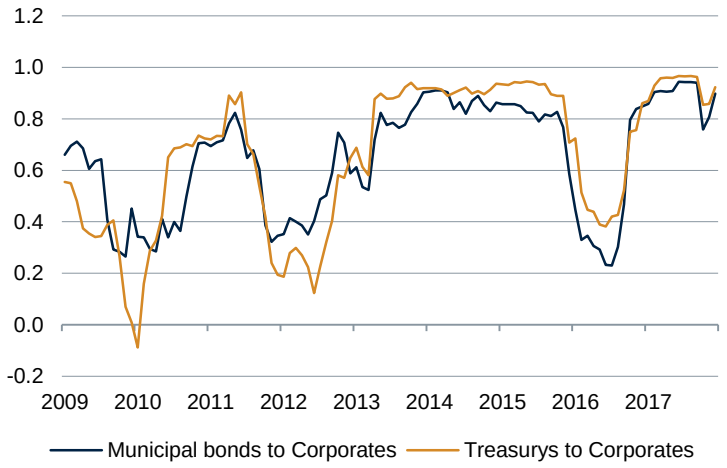
Scarcity

Another factor in evaluating tax-preferenced bonds is whether they can allow insurers to better match their longer-term liabilities with less concentration risk. Since the financial crisis, the general ratings of corporate issuers in the bond markets have been in decline, with very few remaining AAA and AA-rated companies left. For insurers looking for longer dated high quality credit, this increasingly pushes them into a more concentrated position in just a few names. Expanding the available issuers, particularly in higher-rated issuers, can help insurers fill in holes in their credit/maturity spectrum.

Correlation benefits

Municipal bonds also offer correlation/diversification benefits relative to corporates. Their correlation characteristics are similar to that of Treasuries, as shown below:

Rolling one year correlations



Particularly where the muni-to Treasury ratio is favorable, this can allow insurers to achieve risk reduction through diversification while also generating additional spread, thereby improving overall risk vs. return.

State Deposits

Finally, for insurers required to maintain state deposits, municipal bonds are frequently allowed as collateral by state insurance departments. In situations where the state deposit requirements are being met using Treasuries, municipal bond securities may represent a more efficient way to meet state deposit requirements.

Conclusion

Ultimately, the relative attractiveness of tax-preferenced municipal bonds versus taxable bonds will depend on a mix of quantitative and qualitative factors, with after tax yield likely being the dominant consideration. As those yields, and the ratio of tax-preferenced to taxable yields change over time, life insurers should establish an analytical framework and bands of interest to be able to quickly respond to changes in the market.

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