Rudolph
FINANCIAL CONSULTING LLC

August 2015

Incentives and Benchmarking

By Max J. Rudolph, FSA CFA CERA

I first wrote about the risk of low interest rates in 1999, following a talk I gave at the SOA spring meeting, for a LOMA magazine. At time we were pricing with 6.5% as the long-term earned rate, so graded to that over a few years and then held it level. As rates dropped I recall wondering if I should grade UP to 6.5% to be fair to my clients (we didn't), and now I wonder if there really is a floor to rates.

In July I posted a research project titled *Transition to a High Interest Rate Environment: Preparing for Uncertainty*. I led a team including Dr. Randy Jorgensen and Karen Rudolph, with conclusions written by me, where we considered rates even lower than we find today as well as increasing rates. Rates increasing slowly, say 50 bp per year, was essentially both a best case and the median scenario created by the ESG used by the NAIC (I was involved in preparing it for use, and from low rates the mean reversion feature dominates). For some companies this is a base scenario. Others unwind the yield curve, using its normal positive shape to demonstrate that rates will soon increase.

One section of the paper details the results of a practitioner survey, seeking out how companies test for interest rate risk. In my opinion the range is too narrow and too close to the best case results. Companies should run the NY 7 scenarios with no floors of any kind. They should also add stress scenarios that increase by at least 10 per cent over 3 years or less. Few companies are currently doing either, and most practitioners seem to be hoping that rates will increase rather than testing their block of business for tougher scenarios.

Few companies have developed baseline scenarios utilizing benchmark investment strategies. Instead, many have made bets arguing that rates are likely to increase so the investment portfolio should remain short or retain a large portion in cash. The rate increase is just around the corner. The argument in early 2015 was that the Fed would soon increase rates. My prediction, published in January, was that rates would not increase this year due to the tightening effects of winding down the current quantitative easing program. And if no increase happens in 2015, will Chairman Yellen be able to raise rates during an election year?

In any case, my argument here is that company managements are getting a free pass with their incentive plans. They make a bet by holding cash rather than invest it in low yielding assets, then override the incentive plan with the actual earned rates before determining their payouts. Company boards should hold them accountable, but they don't

understand the tactic. Boards are supposed to have financial literacy and risk expertise, but they often stretch the truth. Actuaries would be great sources for these roles, especially experienced CERAs.

Incentives are the driving force behind an employee's motivation. Allowing this trickery does not improve decision making in the long run.

Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!