

*Insight from Nease, Lagana, Eden & Culley, Inc. – Atlanta, GA*

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As the financial services industry works to rebound from the financial crisis, analysis of the impact on life insurance carriers, reinsurers, and products continues. While carrier financial strength and market volatility remain a concern, some are seeing positive signs in the marketplace that will help to restore confidence for both existing policyholders and those exploring a life insurance purchase. In August, Moody's Investor Service, a leading industry rating agency, issued an encouraging, and somewhat cautious, review of the insurance industry. Over the first half of 2009, there were a number of developments—both good and bad—affecting the credit of North American life insurers. Of late, these have been mostly positive, but the life insurance industry still faces an uphill battle. Certain companies have clearly benefited more than others, as a number of companies took advantage of a thawing in the financial markets to raise significant capital and protect their credit profiles against a downside scenario.

The life insurance industry appears to be on the road to recovery, but as is the case for many industries, the road will be bumpy as companies contend with ongoing volatility in the equity markets, heightened fixed income impairments, and potentially troubled commercial real estate investments. Highlights from the Moody's reports are as follows:

## **Investment Grade Bond and Commercial Mortgage Defaults Continue**

Asset impairments and losses are expected to remain elevated over the remainder of the year, and will constrain industry profitability and capital adequacy. The rally in the credit markets in 2Q09 helped to narrow unrealized losses, but Moody's main focus continues to be on ultimate economic losses.

Although the industry has some exposure to below-investment grade bonds and equities/alternatives, its key exposure is to the performance and default rates of the very substantial portfolios encompassing investment grade bonds and commercial mortgage loans. During the first half of 2009, most insurers experienced substantial credit migration in structured securities (particularly residential mortgage backed securities) and financials, resulting in greater exposure to below-investment grade bonds and much higher regulatory capital requirements.

Moody's believes that reported investment losses will continue to slowly drag on throughout 2009 (at 100-200

basis points of invested assets) and continue in 2010, given the steady pressures on most asset classes and the industry's practice of delaying losses until impairments are actually apparent.

## **Access to Capital Markets Unfreezes**

The capital raised in recent months by a number of life insurers in the second quarter of 2009 definitely helps mitigate some downward pressure on company credit profiles under a stress case scenario. The extent of the benefit depends on the following: 1) the form of the capital raise; 2) how capital is deployed; and 3) whether capitalization was seen as a primary weakness.

Moody's notes that the capital markets have opened up in a somewhat selective manner; certain companies perceived to be stronger have benefited, while others with more serious challenges have struggled to raise cost-effective capital.

## **Government Support (e.g., TARP, CPP) Only Taken by Two Carriers**

Given the thawing of the capital markets for many insurers in the second quarter of 2009, the majority of insurers eligible to participate in the Treasury Department's Capital Purchase Program (CPP) elected not to participate. Of the six insurers eligible to do so, only Hartford Financial Services Group and Lincoln National Corporation elected to accept government funds.

The receipt of TARP capital improved these companies' overall financial flexibility. Offsetting this benefit, however, is the perception in the marketplace that these companies are weak. This stigma may hurt the reputations and franchises of the participating companies. Further, the operational conditions and restrictions that accompany TARP participation could create additional challenges. Conversely, carriers who had access to TARP funds but declined to take it—instead choosing to address financial challenges without government assistance—have enhanced their public perception and demonstrated a level of financial strength that has instilled confidence in both Wall Street analysts and policyholders.

To the extent that fresh capital—whether external debt/equity or TARP preferred—materially increases the companies' capital and liquidity buffers and/or financial flexibility, Moody's sees this as improving credit quality. This, in turn, would prevent future downgrades and/or allow stabilizing outlooks, which are still currently negative for most of the life companies.

While Moody's comments are encouraging, challenges remain, making it increasingly important for policyholders and prospective buyers—and their advisors—to select highly rated, financially strong carriers. It is also important to consider the differences between the interests of stockholders and policyholders.

Stockholders are focused on the future earnings of insurance companies. Price declines across life insurance stocks reflect that the markets expect higher capital costs and declining investment portfolio returns to erode the earnings that shareholders may have expected. A declining stock price (or as has been the case for some carriers over the past six months, an increasing stock price) does not directly impact the operations of the company with respect to policyholders; however, it does indirectly impact the amount and cost of capital that a company could raise should the need arise.

Policyholders are focused on solvency: a life insurer's ability to honor the contract in place and pay a claim if submitted. Again, a declining stock price does not directly impact a carrier's solvency. In fact, there are a number of safeguards (conservative reserves and capital, high quality general account assets, separate account assets, and state insurance regulations) that may provide policyholders meaningful comfort in volatile times. To look at it a bit differently, when you buy insurance you are not buying the stock of the insurance company. Instead, you are purchasing an asset that is subject to strict regulations designed to protect policyholders.

## A.M. Best Publishes Special Report on Reinsurers

Also in August, A.M. Best, another leading rating agency, published a report on the strength of reinsurers and the reinsurance market. Reinsurers—which share the risk of life insurance policies with the issuing carriers—have a significant impact on product features and pricing.

In the report A.M. Best detailed their stable outlook on the reinsurance market, which is the result of favorable operating results, improved capital market conditions, and rallies in the stock market. The report also notes that two years into the global financial crisis, reinsurer performance to date could be counted as an achievement given the current state of the financial services industry and the economy.

A.M. Best's stable outlook for the reinsurance sector implies that most reinsurers' ratings are likely to be affirmed in 2009. Factors that could change this outlook to negative

include reinsurers' ability to maintain current pricing and manage aggregate exposures, as well as potential drains on capital due to investment setbacks.

## Client Reaction to the Financial Crisis: Face Amount Reductions

As a result of the financial turbulence in today's economy, policyholders may have smaller projected estate values or less cash on hand to pay insurance premiums. This has led some policyholders, and their advisors, to consider reducing the face amounts of existing policies. While a face reduction appears on the surface to be a simple and easy solution, there are a number of factors to evaluate, including product restrictions and charges.

It is important to consider the following factors before taking action to reduce the face amount of an existing policy.

### *Health of Insured*

Keeping the original death benefit may be more valuable if the policyholder's health has deteriorated.

### *Economic Rebound*

The amount of future death benefit a policyholder needs may rebound in an economic recovery; depressed estate values and a lack of liquidity may only be temporary.

### *Underwriting*

If a policyholder proceeds with a face amount reduction now, but wants to increase the face amount later, new underwriting will be required. At best this requires additional work and time for both the policyholder and the advisor. At worst the client will be faced with a cost increase for the additional coverage, or may even be denied coverage due to deteriorating health.

### *Beneficiaries*

By keeping the original face amount, the full target value will ultimately be received by the beneficiaries (i.e., full death benefit value is preserved for the beneficiaries).

### *Extended Term*

If cash is not readily available to fund future premiums, consider extended term. Extended term preserves the original face amount but reduces or eliminates future premiums by reducing the number of years of death benefit coverage. Inforce rejections are required to evaluate the reduced term of death benefit coverage, and can be used to evaluate future catch-up premiums to restore the projected death benefit coverage for life. Downside scenarios should also be reviewed to assess the leveraged impact on the reduced number of years of death benefit coverage.

Extended term may be a reasonable option if the projected number of years of death benefit coverage is beyond life expectancy (especially if the insured's health has deteriorated).

A client's ability to reduce the face amount of an inforce policy may be limited by restrictions in the contract. Related product charges may also be prohibitive. The following is an overview of the restrictions and charges to consider.

## *Inforce Rejections*

Some product inforce rejections systems may not have the ability to reflect face changes and premium changes, which will create challenges in making an informed decision regarding the amount of the face reduction and the resulting impact on premium required.

## *Partial Surrender Charge*

Some products assess a partial surrender charge for face amount reductions. If the partial surrender charge exceeds the policy's cash value (or shadow account for NLG), additional premium is typically required in order to restore the account to positive. At the very least, the partial surrender charge will reduce the account value (or shadow account for NLG).

## *Per 1,000 Charge*

Some products have a per 1,000 charge that continues to be applied to the original face amount even after the face amount reduction. This reduces the efficiency of the face reduction.

## *Face Change Restrictions*

Most products have some restrictions on face changes, such as:

- No face amount reductions during the first X years (typically 1 year).
- No face amount increases after a face amount reduction.
- If face amount increases are allowed after face amount reductions, new underwriting is typically required.

To successfully achieve the objective of a face amount reduction, it is essential for the client to consider product performance, restrictions, and costs, as well as alternative strategies. Inforce rejections are critical to properly evaluate the proposed face amount reduction and alternatives.

## **Choosing Life Insurance Products in Today's Volatile Economic Environment**

Purchasing life insurance in the high net worth marketplace is a complex, and at times, difficult, process. From product selection to product performance, there are many factors to consider when buying life insurance. The ongoing volatility in the financial markets can create additional challenges.

Insurance is risk transfer. In its purest form, **Term** insurance, the risk of death (i.e., mortality), is transferred to the insurance company. The premium and death benefit for the policyholder is known and guaranteed. If mortality results are better than expected, the insurance company makes an additional profit beyond the original assumptions. If mortality results fall short of expectations, the insurance company's profit declines. Policyholders have little uncertainty (other than the future claims-paying ability of the insurance company), but also no upside if results are better than expected (e.g., reduced premiums), and no flexibility to access value prior to death should needs change.

Over the past half century, the industry has developed new forms of insurance in which the policyholder shares in the downside risk and upside potential with the insurance company. For example, in Participating **Whole Life** (WL) contracts, policyholders share in favorable mortality, interest, and expense results through policy dividends, which can be used to suspend premiums or increase the face amount. Policyholders also assume some downside risk since dividends are not guaranteed. If experience is worse than expected, dividends may be reduced, potentially requiring additional premiums. However, there is a guaranteed floor to downside performance via the base contract.

Whole Life then gave way to **Universal Life** (UL). Like WL, risks and opportunities are shared with the policyholder; however, they are "unbundled," and more transparent than the "black box" dividend calculations inherent in Whole Life. UL also includes a guaranteed floor for downside performance.

**Variable Universal Life** (VUL) takes the risk and opportunity sharing even further. VUL allows the policyholder to almost completely assume the investment allocation control and investment risk (i.e., no guaranteed floor for investment earnings credited to the contract); in so doing there is a significant upside and downside potential to policy performance. In addition, since the account value of VUL is held in a Separate Account, it enjoys a degree of protection

from insurance company creditors that does not apply to policies invested in the General Account for WL and UL. Note that a Fixed Account option is generally available with VUL; funds allocated to the Fixed Account are included in the General Account and therefore do not have creditor protection.

**Equity Index UL (EIUL)** is essentially a UL/VUL hybrid, with a risk transfer profile that is a combination of the two (equity market participation but with a guaranteed floor and possibly a cap on earnings credited).

**No-Lapse Guarantee Universal Life (NLG)**, with its guaranteed premium and death benefit, acts much like Term insurance (but with guaranteed coverage for life). Even in cases where the policyholder assumes some risk, there is often a guarantee provided by the insurance company. For example, Universal Life policies have a guaranteed minimum interest rate, and guarantee mortality and expense loads cannot exceed a specified maximum. It is important to keep in mind that product guarantees are subject to the claims-paying ability of the issuing insurance company.

With all of the negative financial news in the media, it is easy to forget that fundamental insurance concepts still apply. Insurance is transfer of risks but also a transfer of opportunities. The risks/opportunities transferred vary depending on the type of policy, and can include mortality, interest, investment selection, investment return, and expenses. The appropriate product choice should, as always, be based on the policyholder's comfort with the risks/opportunities involved. In general, as the policyholder takes on a greater share of the downside risk, they increase their share of the upside potential. Better than expected experience can result in lower premiums, or higher surrender values and death benefits, than illustrated at issue. Worse than expected experience can result in higher premiums, or lower surrender values and death benefits, than anticipated at issue, or even a policy lapse (if additional premium is not paid).

In addition to the amount of premium required, an important consideration is the flexibility of the chosen product—that is, the ability to access value in the contract prior to death (i.e., cash value), should the policyholder's needs change over time. Although insurance is a long-term investment, having access to cash values can provide emergency cash or income if needed.

Additionally, cash values can be used to fund a policy exchange into a product with better potential performance. Withdrawals will decrease the death benefit and cash value

and may be subject to policy limitations and income tax. Different product types, and even different products within a product type, can have significantly different levels of cash values. Some products have surrender charges, which can significantly reduce cash values in the early policy years; other products contain cash value enhancement riders, usually available for an additional fee, which typically increase cash values in the early policy years and slightly reduce cash values in the later policy years. Of the different product types, NLG typically has the lowest cash values, often producing zero cash values in the early policy years and zero cash values in the later policy years. There are some NLG products that provide enhanced cash values, but the offset is increased guarantee death benefit premiums.

The current economic environment makes it even more critical that policyholders understand product type risks and opportunities, and plan and review accordingly. At the time of purchase, it is important to understand risks and guarantees, which may be quantified with illustrations run at downside scenarios (including guarantees). Understanding the impact of funding policies at different levels, including more conservative premiums that will provide a cushion in the policy to withstand a downturn, is also beneficial. For insurance that has already been purchased, inforce illustrations can provide an early warning as to whether adjustments in funding or death benefit, or even a policy replacement (i.e., 1035 exchange) may be necessary. Inforce reviews may need to be more frequent for aggressively funded policies or for products that contain more risk. Note that inforce reviews may show actual policy performance that is ahead of schedule, providing opportunities for reduced future premiums or for taking cash distributions.

More than ever, opportunities in the life insurance market should be pursued in conjunction with an insurance advisor who understands the complexities of the landscape and the mechanics of the products available. Inforce service—which is provided after the purchase of the policy and remains a hallmark of NLEC's commitment to client advocacy—is also critical. In a volatile environment, it is essential to continuously monitor policy performance and carrier financial strength, and assess the impact of emerging trends.

Nease, Lagana, Eden & Culley, Inc. continues to monitor and evaluate developments relating to carriers, products, and the industry as a whole. If you have any questions or comments, please contact Peter Fleming at 770.956.1800 or [pflaming@nlec.com](mailto:pflaming@nlec.com).