INSURANCE INDUSTRY

IMPACT OF LOW INTEREST RATES ON THE INSURANCE INDUSTRY

Insurance products can continue to fill client needs, but advisors should scrutinize issuers and their offerings.

LAWRENCE J. RYBKA

LAWRENCE J. RYBKA, J.D., CFP® is the president and chief executive officer of Valmark Financial Group in Akron, Ohio.

The metaphor of "not talking about the elephant in the room" is a phrase often used to describe when people avoid directly discussing the real issue that is at the center of what seems like multiple peripherally-related issues. For the U.S. life industry, the elephant in the room is a period of prolonged low interest rates and the impact these low rates have on every element of the U.S. life business. For the last several years, some in the industry have referred to this period as a temporary period of low rates, or as a patch of low rates. Despite temporary upticks, bond yields across the world have been dropping steadily, forming a trend that we expect will continue for the foreseeable future. This has tremendous implications for life insurance products and the companies that issue them.

Product adjustments

These low rates have led to a whole series of related problems, as life companies adjust their products in an attempt to maintain profitability. Such adjustments include:

- Wholesale changes in the life products that insurance companies sell.
- Illustration reform addressing abuses of Index Universal Life.
- Manipulation of insurance company reserves through financial engineering (primarily through captive reinsurance transactions).
- Putting blocks of business into run-off.
- Increasing costs of insurance inside existing policies.

Long-term implications include U.S. life companies being sold to private equity, with a most recent example coming from the announcement of Genworth being sold to a private equity company owned by the former head of the Chinese communist party.[1] This acquisition, if approved, brings to 24 the number of U.S. life companies that are now in the hands of private equity investors.

All of these issues directly or indirectly tie back to or were precipitated by bond yields at or below 3%. These low yields erode traditional margins that insurance companies priced using the anticipated bond yield and the basic guarantees that companies have made in their general account products. In some blocks of business, the spread has gone negative.

Currently, there is a general acknowledgement that these low rates are likely to continue for the foreseeable future. BlackRock's Chief Investment Strategist's forecast is that only 10% of global fixed income securities will have annual returns at, or above, 3% between now and 2021.[2] Furthermore, a recent *Moody's* report[3] acknowledged that low rates are likely to continue for the foreseeable future. This condition of persistent low rates is not unique to the U.S. In fact, the Japanese life industry was forced to deal with a similar set of circumstances ten years ago when these spreads went negative. Japanese bond yields declined ahead of those in the U.S. and remain persistently low. As a result, Japanese life companies saw massive loss of capital through the resulting disintermediation of existing promises to policyholders and low yields, and six of its 15 largest life insurance companies were forced into a national rehabilitation plan to deal with the issue.[4]

In the face of this current reality in the U.S., which follows the experience in Japan, many of those in leadership positions at U.S. life companies, along with state insurance regulators, appear to be refusing to publicly acknowledge, let alone decisively deal with, the issues low yields cause. The reluctance to change the status quo might be for several reasons. Perhaps it would send share prices down further for U.S. insurance stocks, accelerate rating downgrades; or per-

1 Scism and Wu, "China Oceanwide to Buy Genworth Financial for $2.7 Billion." Wall St. J., 10/23/2016, available at www.wsj.com/articles/china-oceanwide-to-buy-genworth-financial-for-2-7-billion-1477263521 (last visited on 12/16/2016).

2 Verhage, "BlackRock: Expect Lower Returns For Pretty Much Everything Over the Next Five Years," BloombergMarkets, 7/25/2016, available at www.bloomberg.com/news/articles/2016-07-25/blackrock-expect-lower-returns-for-pretty-much-everything-over-the-next-five-years (last visited on 12/16/2016).

3 "Low Interest Rates Are Credit Negative for Insurers Globally, But Risks Vary by Country," Moody's Investors Service, 3/26/2015, available at www.actuarialpost.co.uk/downloads/cat_1/Moodys%20Report%202015.pdf (last visted on 12/16/2016).

4 "No Policy is the Best Policy," The Economist, 11/28/2002, available at www.economist.com/node/1468804 (last visited on 12/16/2016).

haps it may force fundamental changes in how the industry is structured, including questioning the whole premise of state insurance regulation. Nevertheless, each of those reasons for inaction does not get rid of the elephant.

The author discussed the phenomenon with one of his firm's most prescient, seasoned veteran producers. He summed up the behavior by simply saying, "All insurance companies lie, they just tell different kinds of lies." Here is an interpretation of his statement in light of current issues:

• Life companies selling whole life imply that they have some kind of "magic bond window" that allows them to continue to illustrate 6% to 7% forever on dividend-based products, despite having to invest in today's low-yield bonds. Northwestern Mutual's recent announcement of the decrease in the interest component of their dividend scale from 5.45% to 5% and increases in expense components of the dividend scale is evidence of the gravitational pull of new low-yielding bonds on its portfolio.[5] Although the actions are likely disappointing for policyholders and will undoubtedly have a detrimental impact on many policies, it is a prudent response to the economic environment.

• Life companies selling index universal life (IUL) project that they can sprinkle a pinch of "magic" derivatives on their 3% bonds and produce a product that promises rates of illustration on policies as high as 8%. Even after "reform" of IUL under Actuarial Guideline 49, companies are allowed to assume for purposes of sales illustrations that they can earn 45% returns on their options in order to illustrate a projected rate of 6%.[6] At the same time these new IUL contracts are projecting unsustainable illustrated rates, they are substituting the 3% and 4% guarantees that were seen in earlier generations of general account contracts with products that have a 0% or 1% guaranteed interest component.

• "Magic" accounting or, as the New York Insurance Commissioner has called it, "a shadow reinsurance market"[7] has allowed carriers to avoid the current earnings hits and ratings pressure of products with long-tailed guarantees. The carriers who sold or are still selling guaranteed products with high embedded interest rate assumptions can make a whole host of optimistic assumptions about the future economics, including higher rates on bond yields and policy behavior in their captive reinsurance companies under GAAP. These assumptions are used as the basis for charging a low current reinsurance premium to their sister companies that actually write the policies. On paper, by doing a deal with themselves, they get the best of both worlds: high statutory surplus in the subs that write the business and roll up high current profits at a parent company level. (The actual results between the captive and the writing entity will depend on actual results and will not have to be reconciled until the distant accounting periods.) Certain state insurance commissions have taken the lead in accommodating this behavior to bring jobs and premium taxes.[8] Hopefully, recent moves by NAIC, S&P, Best, and (most notably) the SEC requiring hidden leverage of captives to be quantified may be enough to nudge them in the right direction and avert a major crisis.[9]

• Finally, private equity firms have brought their own "Wall Street financial magic" to the life industry, attempting to turn blocks of unprofitable low-interest-rate policies into super-charged investments with 15% to 20% returns on equity for their investors. They use the same "magic accounting" of captives but with even greater leverage and out of the view of pesky SEC reporting. Their plans not only involve leverage of the liability side, but to goose up the balance sheet by making more aggressive investments in their general account. These accounting gimmicks allow the substitution of "hard assets" on the balance sheet with a credit for reinsurance, allowing large profits to be withdrawn. The vast majority of transactions involving U.S. life insurance companies since the financial crisis have been to these groups.

At the end of the day, the basic question remains, "How does an insurance company buy a 3% bond, paying all the first year premium in the form of loads and commissions, and create a cash value life contract that both allows the company to make a profit and still provide consumer value?" Perhaps the answer is that they cannot, at least not on the terms promised to the consumer. All

5 "Northwestern Mutual to Pay $5.2 Billion In Dividends to Policyowners," 10/26/2016 Press Release from Northwestern Mutual, available at www.northwesternmutual.com/news-room/123021 (last visited on 12/16/2016).

6 Actuarial Guideline 49 (aka Actuarial Guideline YY). *Product Matters,* October 2015, and Belth, "No. 69: Indexed Universal Life—Debate over Sales Illustrations," 9/30/2014.

7 Lawsky, "Shining a Light on Shadow Insurance: A Little-Known Loophole That Puts Insurance Policyholders and Taxpayers at Greater Risk," NY State Department of Financial Services, June 2013.

8 Belth, "No. 73: Iowa and Nebraska—More on Frightening Accounting Rules," 11/19/2014; Belth, "No. 71: Iowa's Frightening Insurance Accounting Rules," 11/6/2014.

9 "Methodology: Treatment of U.S. Life Insurance Reserves and Reserve Financing Transactions," S&P Rating, 3/12/1015.

of the above mentioned "gimmicks" or "lies" dodge this basic question.

For life insurance professionals, these circumstances raise this question: How should clients be advised in a professional and ethical manner? Ignoring them is neither ethical nor professional. There is a chance that these issues may address themselves, if rates recover soon and gradually enough, to allow these policies to balance. Alternatively, perhaps a whole series of regulatory reforms and moves by the rating agencies aimed at addressing symptoms of these problems might be effective.[10] But thoughtful insurance professionals who really want to objectively advise and protect clients must start by admitting low rates are the elephant in the room. As Dan Sullivan the founder of the Strategic Coach said, "All progress begins with telling the truth."

Five key strategies for long-term success

This article is not an in depth attempt to address the technical issues involved with these challenges. Instead, it is a call to action for informed ethical insurance professionals who wish to advise clients based on actual economic reality of the financial instruments that underlie the products, instead of the hyped illustrations that have disappointed policyholders.

Insurance professionals must be much more selective of which companies to recommend. The press of low rates has affected company balance sheets and is reflected in the overall decline of insurance company ratings. This is creating a continuing shake out of the U.S. life industry. As U.S. life insurers come to grips with the impact of low rates on their income statements, some holding companies have spun off blocks of "unprofitable" business, and other companies have created "closed blocks of policies." In both cases, it means that policyholders are more likely to see unfavorable pricing actions.[11]

The worst case for policyholders is the sale of their insurance company to private equity investors. Long-term, there cannot be a great product from a bad company, and the long-term interests of policyholders seem particularly misaligned with private equity investors. Insurance company selection is essential. Only a company that has demonstrated that it is committed to the life insurance business for the long run should be considered. Any insurance professional who cannot produce a list of companies with which he or she has purposefully decided to work is neglecting one of the most important elements of success. The likely reason they do not is because they simply have not given enough thought to this important task. This consideration needs to go beyond public ratings to consideration of the actual companies issuing the policies, the type of business they write, and the treatment of existing policyholders.

The author's company has created a whole series of resources and tools to help its financial professionals create their own "select list" of those insurance companies with whom they have purposely chosen to work and quantify the types of policies that are most likely to be sustained by the companies issuing them. Each life insurance company is likely to have dozens of products. Each of these products has complex economic and contractual provisions that must be understood to adequately advise clients.

The insurance professional who has purposefully chosen seven to eight strong companies and then digs in to really understand the policy mechanics of four or five of their best products is much better positioned to provide meaningful recommendations than the sales person with little or superficial knowledge of perhaps hundreds of products and dozens of carriers to which he or she has given little thought. It is also likely that anyone claiming to offer this many carriers has no way of monitoring these policies after the sale.

Start with reasonable economic assumptions in product projections. The most persistent error that the insurance industry has made over the last 20 years is giving in to the temptation to over-promise the benefits of the policy and ignore the non-guaranteed elements. The author's father first wrote about this 25 years ago with his best-selling article, "The Ledger Lie."[12] Life and annuity products must ultimately reflect returns on underlying investments, less expenses and profits. Projections of any kind are just that, and the best insurance professionals have always modeled alternative illustrations to help policyholders understand the impact that lower rates have on the premiums

10 DeFrain, "Expected Changes to Insurance Regulation for Captives and Special Purpose Vehicles." CIPR Newsletter, July 2014; Hamilton, Zayac, Alberts, and Woods, "NAIC Adopts Guidance on Acquisition of Control of US Insurers." Mayer Brown Legal Update, 4/23/2015, available at www.mayerbrown.com/files/Publication/7f4a7f20-1892-44b2-80dc-3999ec1c65a0/Presentation/PublicationAttachment/1e71e9b2-6ac4-4851-bedb-3fb04b8bf07a/Update-NAICAdoptsGuidanceonAcquisitionofControlofUSInsurers.pdf (last visited on 12/16/2016).

11 Creswell and Walsh, "Why Some Life Insurance Premiums Are Skyrocketing," N.Y. Times, 8/13/2016, available at www.nytimes.com/2016/08/14/business/why-some-life-insurance-premiums-are-skyrocketing.html?_r=0 (last visited on 12/16/2016).

12 Larry S. Rybka ,"The Ledger Lie," Best's Review, August 1989.

clients will pay or the benefits they will receive from a product.

The starting place for this kind of analysis is a basic forecast of bond and equity yields and then conforming illustrations to rates that are consistent with the underlying instruments insurance companies hold. For example, if one believes the BlackRock forecast to be accurate, general account yields and corresponding crediting rates and dividend assumptions must be reduced in the illustration so that policyholders may gain a more realistic expectation of what low rates will mean to premiums they will pay on a life insurance policy. It also follows the thought that if bond yields will be at or below 3%, corresponding equity yields will also likely be lower as well.

Consider diversification of policies. Whenever a client is relying on a single insurance contract for a significant part of his or her retirement or estate plan, consider diversifying this coverage among quality carriers. This caveat is even more important when the products are general account products. In connection with writing this article, the author reviewed materials his company complied in 1995 that included a list of major life companies. Two-thirds of the names on the list are no longer stand-alone entities, and many of the carriers on the list have seen significant downgrades in their ratings.

Apply the fundamental principles of asset allocation to insurance: If it does not make sense to recommend that a client allocate a significant portion of his or her net worth to ten- and 15-year bonds in this rate environment, perhaps it does not make sense to buy an insurance product that has to lock in these same bonds. The fundamental value proposition of separate account life and annuity products (variable life insurance), bracketed by contractual guarantees that offer favorable features and taxation, may offer a much more compelling long-term value proposition for policyholders. Besides providing transparency and greater potential for appreciation, the separate accounts give clients the best independent protection from purposeful or inept carrier behavior.

Only work with insurance professionals who can demonstrate they provide ongoing policy monitoring: Cash-value life insurance policies of all types require active monitoring and management. The real difference between insurance professionals should be measured after the policy is issued, with most agents disappearing after the policy is sold. Changes in credited rates, dividend scales, and performance of sub-accounts in variable products mean that whatever was illustrated is likely to vary from how the policy is actually performing.

Likewise, if the policyholder varies the premium paid or changes the policy in any way, it can have an immense impact on the policy. This is especially true in universal life policies with secondary guarantees that have contractual provisions to extend the policy beyond age 100. While these are very valuable contractual features, these guarantees must be actively monitored for even slight variation in the amount or timing of the premium.

Although these products mitigate specific risk of decreased crediting rate or dividend scale, they have very high administration risk if premiums vary, making for the policies that are most in need of ongoing monitoring and management. The author's firm thought this was such an important part of the long-term life insurance value proposition that it created a separate Policy Management Company, with dedicated software and staffing to allow ongoing management and monitoring of clients' in-force life insurance policies for our advisors who wanted to make this service a priority.

Conclusion

Good life insurance policies remain a part of the essential foundation for many clients' financial plans. They are unique in their ability to provide tax-favored death benefits to continue income for families and allow for orderly continuation of business. Properly structured, policies from good companies that are actively managed may be, for many, the most important asset in their portfolio. For policies to reach their full potential, however, clients and their advisors must address the elephant in the room.

Thoughtful insurance professionals who really want to objectively advise and protect clients must start by admitting low rates are the elephant in the room.

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