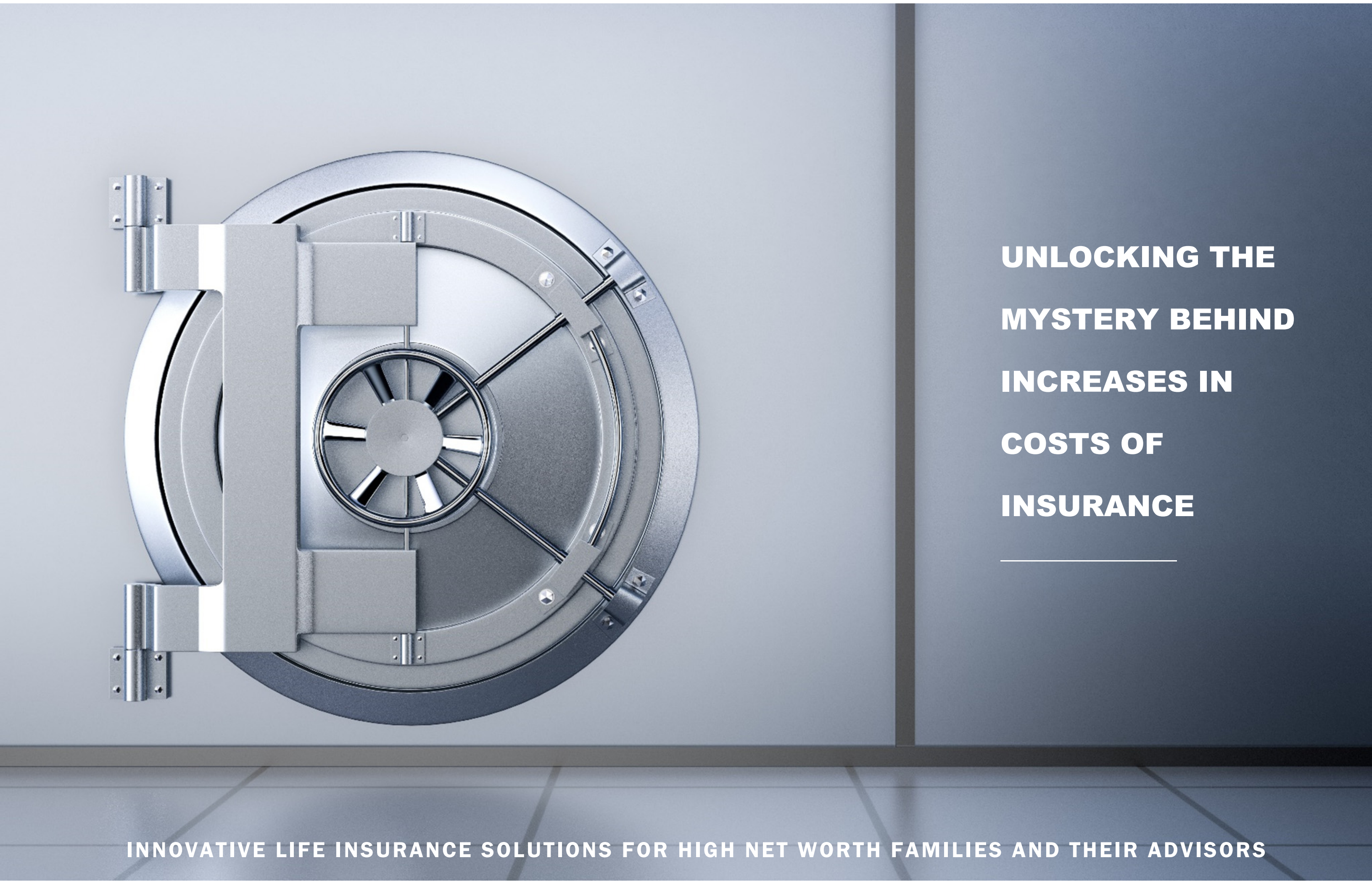
ADVISOR BRIEFING



UNLOCKING THE MYSTERY BEHIND INCREASES IN COSTS OF INSURANCE

What are some of the reasons causing insurance carriers to increase Costs of Insurance Charges on your clients' policies and what can advisors do to address these increases?

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THE SITUATION

Cost of Insurance (COI) Charges have historically been an uncommon element that life insurance carriers have adjusted in response to financial pressures. While there have been limited instances of increases in the past 30 years, starting in 2015 several carriers applied increases to COI Charges of certain blocks of in-force policies, mostly consisting of the "Universal Life" type. Even though all increases have been within contractually guaranteed limits, this break in tradition and the significant amount of the increases have raised questions and fomented emotions among advisors and clients.

What are some common reasons causing carriers to increase COI Charges?

The visible economic problem:

LOW INTEREST RATE ENVIRONMENT

- To manage reserves and cover future liabilities, carriers invest their assets in highly-rated corporate and government bonds. As new money is received and older bonds mature, investments in new bonds have less than historical yields due to sustained low interest rates, causing a decline in carriers' investment yield.

- With Universal Life (UL) policies, a primary driver of carrier profitability is the spread between its investment yield and the interest rate credited to the cash values of in-force policies.

- Declining investment yields have forced carriers to lower crediting rates accordingly, which can only be done to the extent that rates equal or exceed contractual minimums. This can cause problems with older blocks of policies sold with higher guaranteed rates, such as 4%-5% in the 1980s and 3%-4% in the 1990s. (Guaranteed rates today are in the 1%-3% range.)

- Today, the 10-Year Treasury yield is around 3.3%, long-term corporate bonds are in the 3%-4%range, and carrier general accounts are lagging around 4%-5% causing tremendous yield compression, especially on older policies where yields may have reduced to the contractual guaranteed, in some cases requiring yield subsidy.

- One of the primary assumptions in pricing insurance policies is regarding the "yield curve" or the prediction of future interest rates. Most insurers assume some degree of "return to the normative curve", meaning rates will rise in the future. Over the past 6-8 years, this assumption has been false.

- Aside from increasing investment in riskier assets to achieve higher returns than bonds and boost yield, which some carriers have done, the only option left to manage the Cost of Insurance and profitability of certain policies may be increasing COI Charges, to the extent the contracts allow.

Stressed investment earnings can amplify the negative effects of other pressures.

Some of these other pressures include higher cost of mortality, higher reinsurance costs, lower lapse ratios, and adverse premium payment experience. These additional pressures can have the effect of increasing the overall "Cost of Insurance" to a carrier but, in the past, were often able to be absorbed by higher investment earnings. Today, due to low interest rates, they can magnify a carrier's overall financial challenges and cause a greater willingness to consider raising COI Charges. When interest rates rise to normal levels resulting in healthier investment earnings, pressures on COI Charges may lessen. In the meantime, it's possible that additional COI Charge adjustments may occur so **adequate in-force policy monitoring by clients and advisors is vital.**

What actions can clients and advisors take to address increased COI Charges?

- **Review a carrier's historical changes** that it has made to non-guaranteed elements of in-force policies. It can provide some insight into the carrier's track record for pricing and managing non-guaranteed elements.

- **Pay attention to public comments by senior leaders** at carriers, such as quarterly analyst calls or press releases, which might indicate in-force policy actions. For example, one carrier's CEO recently stated on an analyst call that in-force policy COI Charges would be targeted as yield subsidy. Conversely, another carrier recently sent a press release that announced that at the present time it does not intend to raise any COI Charges.

- **Conduct annual policy reviews** by requesting in-force illustrations and compare the illustrated vs. actual performance to monitor if it is on track to meet the client's needs.

- **If the projected performance is insufficient** to meet the long-term goals, consider one or more of the following actions.

  — Reduce the face amount or increase premiums.

  — Let the current premium and face amount persist as long as possible and pay higher "catch-up" premiums later.

  — 1035 exchange cash value to a new life policy that is economically better, if the insured can medically qualify.

  — If the insured can't qualify, and if any required adjustments to meet long-term goals are cost prohibitive, 1035 exchange the policy to an annuity, surrender it for its cash value, or sell it to a life settlement company if possible.

  — The value realized by the options in the last bullet should be heavily weighed against the need for the death benefit long term and the corresponding cost it would require to maintain it.

Why is advisor independence and objectivity more important now than ever to meet client needs?

A private survey conducted by Harris Poll in May 2014 illustrates an astonishing level of ignorance among policy owners with respect to life insurance policies recently purchased.

- 29% said they haven't reviewed their policies since they were issued.
- 60% think the policy terms are "set in stone" (which may or may not be the case).
- 60% believe their policy benefits are guaranteed forever (which may or may not be the case).
- 47% say their insurance agent never recommended a review of the performance of their policy.

The Elder and Special Needs Law Journal (Winter 2014) further reinforces lack of adequate management of in-force policies:

- 90% of trust-owned life insurance policies are managed by private trustees such as family and friends, of which 70% had not been professionally reviewed since 2008.
- Of the 10% of trust-owned policies managed by professional trustees, 83% of the trustees admit to not meeting the Uniform Prudent Investor Act guidelines.

These statistics greatly reinforce the need for independent, objective advice to help clients understand and manage the performance of their life insurance policies...advice that starts with and necessitates having access to the entire marketplace of carrier and product solutions. Independence is crucial to ensure that the client's needs are adequately met both when coverage is originally purchased and when alternatives need to be considered in response to changing circumstances.

Many insurance advisors claim to be "independent" because the insurance carrier that owns their agency provides an "open architecture" in which other carriers can be accessed. However, in many instances, the primary carrier may heavily incentivize or pressure its advisors to write business "in house."

Thus, despite the open architecture, many advisors may maintain a bias toward the specific products of the carrier or organization that owns their firm or agency. True independence involves more than just having "open architecture." It means having a sophisticated approach and advanced expertise to navigate the open architecture as well as true objectivity that is essential to advise clients effectively.

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INSIGHT Insurance Portfolio Analysis