

Module 11: Life Insurance

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Unit 3: Life Insurance Market Conditions and Products – Part 1

Case Study 07: The Life/Health Industry in the Economic Recession of 2008– 2009

Unlike property/casualty carriers, the prosperity of life insurance companies is closely linked to the health of the broader financial network. Investments make up a significant portion of industry profits, and they are the driving component behind product delivery. Because of the economic recession, life annuities promising minimum payments are particularly strained; in many cases, their guarantees are no longer supported by underlying investments. Those underlying investments consist of stocks, commercial mortgages, mortgage-backed securities and corporate bonds. Market devaluation, default, or interest rate reductions have harmed all of these funding sources. Consider that the asset mix of life insurers in 2007 included \$387.5 billion worth of MBSs; by way of comparison, the property and casualty insurance industry held \$125.8 billion.

An insurers' net worth is expressed in the form of capital and surplus (assets minus liabilities). Insurers must have capital that is sufficient to satisfy their liabilities (mainly in the form of loss reserves). In 2008, surplus declined by 4.7 percent for the top one hundred life insurers. This drop was mitigated somewhat, however, by successfully raising new capital in 2008. Nonetheless, investors will be none too pleased with the return on equity ratio of -0.3 percent, down from 12.8 percent in 2007. With little bargaining power, the industry may be able to raise new capital in the future only at less-than-favorable terms. Conning Research and Consulting estimates that surplus for the entire industry could be off by as much as 24 percent in 2008. Low interest rates and investments that are not simply depressed, but highly volatile, are cited as the reasons for the industry's shrinking assets and surplus.

Twelve life insurers, including MetLife, Hartford Financial Group, and Prudential, have applied for aid through the government's Troubled Asset Relief Program (TARP). TARP, signed into law October 2, 2008, pledges \$700 billion worth of federal spending toward the purchase of assets and equities of imperiled financial institutions. As of this writing, the U.S. Treasury has decided to include insurers in the TARP program. (AIG is a special case, in a class all its own.) At the end of 2008, unrealized losses amounted to \$30 billion for MetLife, \$15 billion for Hartford, and \$11 billion for Prudential. Nonetheless, company officials insist that their firms are adequately capitalized to meet current liabilities.

On February 27, 2009, in line with previous moves by fellow rating agencies Fitch and Moody's, Standard & Poor's (S&P) lowered its financial strength and credit ratings on ten groups of U.S. life insurers and seven life insurance holding companies, respectively. Organizations implicated include Metlife, Hartford, Genworth Financial, Prudential, and Pacific LifeCorp. S&P's analysis focused on poor investment, performance, equity declines, and company earnings volatility. On the bright side, Massachusetts Mutual Life, New York Life Insurance, and Northwestern Mutual in particular have retained triple-A financial strength ratings as of this writing. After these downgrades, the American Council of Life Insurers (ACLI) lobbied the National Association of Insurance Commissioners (NAIC) for lower capital and reserve requirements. The ACLI, a trade organization of 340 member companies accounting for 93 percent of the life insurance industry's U.S. assets, said that their proposal would give a financial cushion and restore some operating flexibility. The NAIC denied the request on January 29, 2009, with president and New Hampshire insurance commissioner Roger Sevigny stating, "So far the insurance industry is in much better condition than most of the rest of the financial services sector because of strong state solvency regulations."

With respect to the health segment, there has been a longstanding assumption that health care was a recession-proof industry due to the fact that people become ill and need medical services regardless of economic circumstances. The current recession is casting doubt on this

notion. As of this writing, 60 percent of Americans have health insurance through employer-sponsored plans. The recent advent of high-deductible health plans and their adoption by employers has increased personal responsibility for covering health care expenses traditionally paid by insurers. (Both employer-sponsored health options and high-deductible health plans are covered in Chapter 22 "Employment and Individual Health Risk Management".) Financially strapped employees are thus forced to choose between paying for medical services or paying their mortgages. On the one hand, the delaying and avoidance of medical services by insureds could bode well for health insurers' loss experience. At the same time, however, with unemployment rates at their highest since 1982, the overall insured population has decreased over the course of the recession. To quantify, the Center for American Progress estimates that 4 million Americans have lost their health insurance since the recession began; up to 14,000 people could be losing coverage every day. The Center correlates each 1 percentage point rise in the unemployment rate with 2.4 million Americans losing employer-sponsored health insurance. Individual health insurance plans are an option, but they are frequently cost-prohibitive to the unemployed unless they are young and in the healthy pool. Those who do remain insured but reduce their consumption of medical services have less demand for health insurance. Consequently, they could drop all but the most basic and necessary health coverage options. Therefore, it is difficult to imagine potential improvements in loss experience offsetting the effects of a shrinking population of insureds.

As further evidence, consider that the top eight health insurance plans in the United States cover 58 percent of the insured population. These insurers have faced challenges over the course of the recession. For example, UnitedHealth Group saw the profit margins on its Health Care Services unit fall from 9.3 percent to 6.6 percent between September 30, 2007, and June 30, 2008. This may not seem significant, but stable profit margins help to contain premium costs in health insurance. The top eight plans have also experienced slowdowns in enrollment growth, a trend that could see enrollment contract as the recession persists.

In response to recessionary pressures, the life/health industry has scaled back on aggressive product development efforts to save costs and meet changing consumer demands. Life insurers are reporting an increasing preference among clients for term rather than permanent insurance. Insureds are also cutting the face value of their policies to reduce premiums. President of Genworth Retirement Services Chris Grady stressed, “The industry has to develop simple retirement income solutions, simple processes and simple marketing” to cope with current market conditions. To their advantage, life insurers’ needs for new capital are partially subsidized by highly liquid premium revenues. Fortunately, the fundamental drive for the security provided by life insurance is strong, and especially so during uncertain times. As for health insurance, the Deloitte Center for Health Solutions expects that individuals will delay primary and preventive care, people with high-deductible health plans will put off making payments, and medical debt bankruptcies will rise. Insurers will adjust by shifting more costs to insureds in the form of higher premiums, deductibles, and copayments and by enacting stricter policy provisions.

On March 12, 2009, the *Wall Street Journal* reported that the Dow Jones Wilshire U.S. Life Insurance Index had fallen 59 percent for the year to date. For the life/health segment, the recession did not hit full-force until the fourth quarter of 2008 due to high losses from investments. Because of accounting rules, the impact of these losses may not be realized on insurers’ books until late 2009 into 2010. FBR Capital Markets estimated that realized credit losses over the preceding two years could top \$19.2 billion, exceeding the industry’s projected excess capital of \$17.5 billion through 2010. If such a shortfall materializes, it will entail raising new capital, government intervention, or dissolution of distressed companies. Going forward, Conning Research and Consulting predicts significant consolidation within the industry. With life insurers holding a reported 18 percent of all outstanding corporate bonds, the health of capital markets is highly dependent on the activities of life insurers. The 63 percent decline in private bond and equity purchases by life companies in the fourth quarter of 2008 certainly contributed to the depression of capital markets, which is projected to persist until investment activity improves.

Similarly, with health care expenditures accounting for 17 percent of gross domestic product (GDP), recovery of the overall U.S. economy is projected to be influenced by the performance of the health industry. The Obama administration has targeted health care as a major area of reform, and the American Recovery and Reinvestment Act of 2009 contains some provisions for health care. These and other efforts will be discussed in Chapter 22 "Employment and Individual Health Risk Management".

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Module 11: Social Security

Unit 6: Group Life Insurance

Case Study 08: Do Viatical and Life Settlements Have a Place in Today's Market?

Do Viatical and Life Settlements Have a Place in Today's Market?

Viatical settlements involve the sale of an existing life insurance policy by a terminally ill person to a third party. Viaticals saw their heyday during the late 1980s as AIDS patients with little time left sought funds to live out their final days or months with dignity. Numerous companies were formed in which individuals invested in the life insurance policies of AIDS patients, essentially betting on the short life expectancy of the policyholder. The investor would give the insured about 80 percent of the death benefits expecting to generate a large return in less than a year when the insured passed away and the proceeds would be collected by the investor/beneficiary.

With the advent of protease inhibitors in the mid-1990s, the life expectancy of people with AIDS increased dramatically. AIDS viaticals no longer looked like such a good investment. But the industry has not disappeared. Today, companies selling viaticals seek out individuals with other terminal illnesses, such as cancer or Amyotrophic Lateral Sclerosis (ALS, otherwise known as Lou Gehrig's disease).

Viatical settlements are possible because ownership of life insurance may be transferred at its owner's discretion. Viatical settlement firms typically buy insurance policies worth \$10,000 and more from individuals with one to four years left to live. Both individual and employer-provided life insurance (group life) policies can be sold. Once sold, the new owner pays the premiums. The former owner uses the settlement money for anything from health expenses to taking that last dream vacation.

The option to receive a portion of the life proceeds before death is not new. The accelerated benefit option in life policies allows terminally ill policyholders access to the death benefits of their policies before they die. In such a case, a percentage of the face value (usually 50 percent or less) is paid in a lump sum to the policyholder. The rest of the insurance is paid to the beneficiary at the time of death. The low amount available under the accelerated benefit option is the impetus to the development of the viatical settlement companies. With transfer of ownership, the insured can get much more than 50 percent of the policy amount. According to Conning estimates, for a policy with a death benefit of \$1.5 million, the typical payment would be \$450,000 with a commission to the producer of close to \$75,000.

While viatical settlements can provide greatly needed funds to terminally ill individuals, they are not without pitfalls. They pay less than the face value of the policy, but they usually provide higher amounts than the cash value of a policy. Settlement money may be subject to taxation, while life insurance benefits are not. Because beneficiaries may contest the sale of life insurance, which will reduce their inheritance, their advance approval is required. Senior citizens whose beneficiaries have died, however, often have no reason to continue paying premiums and may let their policies lapse anyway. In this case, selling their policy may provide them with funds they would otherwise never see.

Today, life settlements have supplanted viatical settlements in industry headlines. Life settlements are similar to viaticals, with the distinguishing feature that the insureds relinquishing their policies need not have a catastrophic illness (although in some jurisdictions, viaticals are defined broadly enough that there is no practical distinction between viatical and life settlements). Nonetheless, life settlements are marketed toward insureds with actuarially short conditional life expectancies, such as individuals over the age of sixty-five. This feature makes life settlements controversial, like their viatical cousins.

The regulatory climate of life and viatical settlements is tumultuous. Each state has a different view toward buyer practices, and regulatory standards range from nonexistent to draconian. Because sales are secondary-market transactions, some states impose no regulation over settlements. Agents and brokers may also be unlicensed. On the other hand,

some states enforce onerous requirements on life settlement dealings. For example, the Ohio Department of Insurance (DOI) nearly drove life settlement dealings out of the state by calling for detailed information about brokers' transactions. The "self-audit data call" asked for over ninety data elements about life settlement contracts, including sensitive health and personal information about insureds. Brokers doing business in the state claimed the scope of the data call was highly burdensome and that compliance meant a potential violation of Health Insurance Portability and Accountability Act (HIPAA) privacy laws (discussed in [Chapter 20 "Employment-Based Risk Management \(General\)"](#)). Nevertheless, noncompliant brokers were faced with the threat of losing their licenses to conduct business in Ohio. The DOI also wanted life settlement brokers to attest to the accuracy of their data call responses, a caveat that could expose them to litigation by insureds for misrepresentation. Ultimately, the Ohio DOI rescinded its data call request in March 2009 in light of significant criticism by the industry.

In the defense of states with strict regulatory protocols, the life settlement market is far from infallible. A variation known as stranger-originated life insurance (STOLI) has emerged as a new form of life settlement where senior citizens of high net worth become insureds for large death benefits. Premiums are paid by investors who become the owners and beneficiaries of these policies. The seniors usually receive a certain percentage of the death benefits. Because death benefits are not taxable, the life insurance industry is worried that the tax exemption may be lost if investors are the beneficiaries rather than family members. STOLI is a source of controversy because insureds may encounter tax liabilities, have their privacy compromised, and diminish their ability to buy more life insurance coverage in the future. The main problem is the insurable interest issue in some States.

The inconsistent regulatory environment is such that some life settlement transactions are completely illegitimate, as in the case of National Life Settlements (NLS), L.L.C. The company is alleged to have collected over \$20 million from life settlement investors without purchasing any actual policies, according to bank records. NLS had compensated unlicensed brokers and agents in \$3 million worth of commissions but returned only a fraction of the amount collected from investors over three years. The Texas State Securities Board seized the assets of NLS pending outcome of the legal investigation.

In an effort to improve industry transparency and ethical conduct, the National Association of Insurance Commissioners (NAIC) and National Conference of Insurance Legislators (NCOIL) proposed separate life settlements model acts in December 2007. The model acts put forth marketing standards, uniform purchase agreements, bans on STOLI, insureds' limited rights of termination, and sanctions for offenders. As of this writing, twenty-eight states have enacted legislation based on the model acts or their own standards governing life settlements and licensing requirements.

The life settlement business is growing and offering increasingly sophisticated financing arrangements. About \$15 billion in life insurance policies were sold via life settlements in 2006, per the Life Insurance Settlement Association. An Internet search for "life settlement" will turn up countless organizations specializing in the service. Maturation of the industry and more standardized regulatory oversight are likely to improve the public's perception of life settlement and its reputation. Consumers are cautioned to be leery of STOLI dealings; conduct life settlements only through institutionally owned and funded entities; clarify all tax implications; and scrutinize contracts for features such as rescission periods, HIPAA compliance provisions, and next-of-kin notifications to protect their interests in life settlement transactions.

Questions for Discussion

1. Is it ethical to profit from someone else's misfortune by buying his or her life insurance at a discount?
2. Are life settlements a good idea for the policyholder? What are their advantages and disadvantages?
3. Do you think there is a need for viatical or life settlements when accelerated benefits are available?

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