



THE INSURANCE DESIGN CENTER, LLC ADVISOR ALERT

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CARRIER SOLVENCY AND THE IMPACT ON POLICYHOLDERS

As insurance carriers continue to face challenges due to the recent economic turmoil, solvency is on the minds of many. Addressing basic questions about solvency, and the implications for policyholders, supports efforts to restore confidence in the life insurance industry. Our team has received many calls about carrier strength and solvency. As such, below you will find commonly asked questions and answers.

It is important to note solvency remains the key focus and must be separated from the media's attention on falling stock prices and bailout issues. Certain carriers are facing capital challenges due to a weakening capital base, and will continue to be subject to concerns involving residential and commercial real estate and variable annuity guarantee exposure. However, in a volatile environment, carriers are responding to the challenges by focusing on core operations – issuing policies, servicing policyholders and paying claims.

First let us address one of the top concerns clients and their advisors have expressed:

WHAT PROGRAMS AND POLICYHOLDER PROTECTIONS ARE IN PLACE AT THE FEDERAL AND STATE LEVEL?

Life insurance, and any protections provided, are regulated at the state level. Specifically:

State Guaranty Funds: Life and health insurance guaranty associations are state entities (in all 50 states, as well as Puerto Rico and the District of Columbia) created to protect policyholders from an insolvent insurance company. All insurance companies licensed to sell life or health insurance in a state must be members of that state's guaranty association. The guaranty association cooperates with the commissioner and the receiver in determining whether the company can be rehabilitated or if the failed company should be liquidated and its policies transferred to financially sound insurance companies. Once the liquidation is ordered, the guaranty association provides coverage to the company's policyholders who are state residents (up to the limits specified by state laws—see below).

While laws governing maximum limits and types of policies covered vary from state to state, most states set basic limits of:

- \$300,000 in life insurance death benefit
- \$100,000 in cash surrender or withdrawal value for life insurance
- \$100,000 in withdrawal and cash values for annuities

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...committed to providing life insurance education, advocacy, and stewardship to private clients and institutions.

The overall benefit “cap” in most states for an individual life is \$300,000, though some states have higher maximums. When an insurer fails and there is a shortfall of funds needed to meet the obligations to policyholders, state guaranty associations are activated. To amass the funds needed to protect the state’s policyholders, insurers doing business in that state are assessed a share of the amount required to meet all covered claims. The amount insurers are assessed is based on the amount of premiums they collect in that state.

Conservative Reserves and Capital: Life insurers are required to hold reserves, within the regulated insurance subsidiary, to cover the cost of all future claims. The required reserves are calculated using a conservative method mandated by state law and regulation. In addition to conservative reserves, life insurers are also required by state law and regulation to hold a capital and surplus cushion. The size of this cushion is based on the types of investment risk in the insurer’s portfolio:

- Asset default risk
- Insurance risk (underwriting)
- Interest rate risk
- General business risk

If the capital and surplus of a company falls below a minimum required level, regulators are required to intervene and take specific action to protect policyholders.

High Quality General Account Assets: Since life insurers are required to hold additional capital and surplus for investments made in riskier assets, most insurance portfolios are comprised of the highest quality assets. These portfolios typically include a well-diversified mix of high quality bonds, commercial mortgages and real estate. Additionally, life insurance company portfolios have much less leverage than banks or investment banks, which results in less portfolio volatility. Liquidity is also an important aspect of a life insurance company’s portfolio. As part of their regulatory filings, life insurers are required to ensure the assets they hold will provide sufficient liquidity to meet policyholder liabilities by modeling thousands of economic scenarios. Therefore, even if the investments noted above (high quality bonds, commercial mortgages and real estate) are adversely impacted by a market downturn, there is comfort—via the modeling process—that sufficient liquidity exists to meet policyholder liabilities.

Separate Account Assets Not Subject To General Creditors: For variable products, premiums invested in the separate account funds are segregated from the insurer’s general portfolio. Generally speaking, state law protects separate account assets for the policyholders of the separate account. This provides an extra layer of policyholder protection that is significant during times of broader financial instability: since separate account assets are not comingled with the insurer’s portfolio, creditors of the insurance company do not have claim to these assets.

Regulated Life Insurance Subsidiaries Have Protections in Place to Protect Policyholder Interests: Insurance regulations provide protections that essentially create a wall between a life insurance subsidiary and the parent company (and other affiliated subsidiaries). These regulations require all assets, reserves, capital and surplus to be held separately by the life insurance subsidiary. In addition, any transfer of capital or surplus to the parent company (or other affiliated subsidiaries) must be approved by regulators. Before approving such transactions, regulators are required to confirm that the transaction would not in any way impair the life insurance company’s ability to pay policyholder benefits.

This protection is notable in the situation with AIG. AIG’s troubles stem from a non-insurance entity, AIG’s Financial Products subsidiary, which was issuing credit protection products. The situation does not involve an impairment of the life insurance operations. These credit protection products have suffered huge losses due to the ongoing credit crisis. The assets within AIG’s life subsidiary are protected by regulation for the benefit of the life subsidiary and must be sufficient to meet the life subsidiary’s liabilities (i.e., assets from the life subsidiary are not allowed to be transferred to the financial products subsidiary).



WHAT HAPPENS TO IN-FORCE LIFE INSURANCE POLICY OWNERS AND THEIR POLICIES IF A CARRIER GOES INTO RECEIVERSHIP?

When a life insurance company goes into receivership, the state regulator essentially takes control of the company. The regulator will appoint a conservator to administer the company while in receivership.

The conservator has three options:

- 1) Restructure the company, which allows the company to continue as an ongoing entity
- 2) Sell the whole company
- 3) Liquidate the company by selling it in parts

During receivership, the conservator has full discretion over payment of claims and benefits, and policyholder protection is the primary concern. Typically, death claims have been paid in full, but surrenders and annuity payments have been restricted.

Before a carrier goes into receivership it must honor the terms of the contract. In general account products, companies typically have six months to make payments. However, due to liquidity restrictions that tend to cause a “run on the bank,” this time frame is typically extended by the state regulator.

When a company’s capital position deteriorates prior to receivership, regulators have the authority to intervene and attempt to manage the company back to financial health.

WHAT HAPPENS TO LIFE INSURANCE POLICY OWNERS (AND THEIR POLICIES) IF A CARRIER IS SOLD (I.E., PURCHASED BY ANOTHER COMPANY)?

The answer to this question has two components:

- 1) The impact on policy guarantees; and
- 2) The impact on nonguaranteed performance.

First the policy guarantees. The purchasing company is contractually required to meet the policy obligations entered into by the company it purchases. All policy guarantees must be met. For no-lapse guarantee (NLG) products, the purchasing company cannot change the guarantees associated with the product. As a result, the premiums needed to guarantee the death benefit should not change. For current assumption products, guaranteed interest credits and charges would continue to define minimum policy performance. On the other hand, non-guaranteed performance could change. This means that for an NLG policy, cash values could decrease (if the new company decreases the crediting rate or increases charges on the current account).

Policy service may also suffer if the new company has challenges integrating the two organizations. Based on past experience, some level of post-merger service quality decline is likely.

For policies that do not have guaranteed premiums, the question is how will the new company treat the in-force block? The new company may be reluctant to increase charges or significantly drop crediting rates on large in-force blocks. The reason for this is that large blocks of business will usually have enough healthy lives that can find a better product elsewhere if product performance declines; leaving only the worst spread of risks that can reduce profitability for the acquiring carrier.

However, it is not unreasonable to assume less care would be taken to treat these in-force policyholders as well as newer policyholders.



HOW IS SOLVENCY RELATED TO THE CONTINUED VOLATILITY IN THE FINANCIAL MARKETS? ARE POLICYHOLDERS IMPACTED BY DECLINING STOCK PRICES?

For publicly traded life insurance companies, there are two key stakeholders: stockholders and policyholders.

Stockholders, those who own stock in a particular insurance carrier, are focused on the company's future earnings. Price declines across life insurance stocks are the result of earnings erosion driven by higher capital costs and declining investment portfolio returns. Prices will typically rebound when investors believe future earnings will improve. A declining 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 (noted above) 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 subject to strict regulations designed to protect policyholders.

While uncertainty persists and solvency remains a question, life insurance may offer a safer port in the current financial storm. The policyholder safeguards noted above, together with products offered by highly-rated, financially strong carriers, may create—under the appropriate circumstances—an attractive opportunity. From a financial strength perspective, it is important to keep in mind that even after the recent wave of carrier downgrades, the industry remains highly-rated, especially when compared to most other financial institutions.

More than ever, opportunities in the life insurance market should be explored in conjunction with an insurance advisor who understands the complexities of the landscape and the mechanics of the products available. In a volatile environment, it is essential to continuously monitor policy performance and assess the impact of emerging trends. Life insurance assets need to be reviewed on a regular basis to ensure the asset will be there when it is needed.¹

¹ Q&A: Carrier Solvency and the Impact on Policyholders, M Due Care Bulletin March 2009

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