2015 In-Force COI Increases: Background, Perspective, and Considerations

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In the face of historically low interest rates, adverse mortality, increased reinsurance rates, and decreased profitability, some carriers have raised cost of insurance (COI) rates for in-force policies. The actions have raised questions, within the industry and among clients and their advisors, about the drivers of the increases and expectations going forward.

The concept of raising prices after a policy has been issued and is in force comes with a variety of perspectives—from necessary to unfair—and has become an area of focus for life insurance manufacturers, distributors, policyholders, and the media. With the varying perspectives, there is no simple explanation or reason that will make all parties comfortable with the COI rate increases. Beyond the emotional reaction, there are facts and circumstances to be considered that serve as a reminder that the information shared with policyholders, and the ways in which advisors advocate for clients, remains critically important.

In the wake of recent activity, and consistent with our commitment to client advocacy, M Financial Group has taken steps to analyze the drivers of the actions and further educate interested parties on the complexities of life insurance products. This paper seeks to:

- Describe the risk-sharing attributes and guarantees of universal life;
- Review insurance carrier profitability and the legal issues driving, and allowing, the COI increases;
- Provide direction and consideration for evaluating policies; and
- Address M Financial's management of the in-force block of M proprietary products.

Background

In 2015, a number of carriers announced COI increases for in-force universal life (UL) policies:

- Transamerica announced an increase to COI rates for certain UL policies (August)
- Banner and William Penn increased COIs for select no-lapse guarantee UL (NLG) plans issued from 1996 to 2008 (August)
- U.S. Financial Life (a subsidiary of AXA) increased COIs on Nova and SuperNova UL (August)
- VOYA increased some of the charges assessed, including COIs, on nine products (UL and NLG) purchased prior to 2009 (October)
- AXA raised COIs on Athena Universal Life II (January 1, 2016)

In general, the increases were primarily designed to restore carrier profitability due to declining portfolio yields on products with current crediting rates at the guaranteed minimum. Some of the carriers also attributed the increases to adverse mortality and increased reinsurance rates.

While it may be purely coincidental, four of the five companies are owned by European parents. The fifth, Voya, was recently a wholly-owned subsidiary of ING Group; the Dutch parent completed its government-mandated divestiture in March 2015.

The only M Carrier to raise in-force COIs is Voya, an M Associate (not Partner) Carrier. The Voya action negatively impacted 28,000 policies, 121 of which were placed by 60 Member Firms and reinsured with M Financial Re. For perspective, M Financial Re currently reinsures approximately 70,000 policies. Concurrent with Voya's announcement, M Financial distributed an analysis to Member Firms (see Exhibit A).

No M proprietary products—products available exclusively through M Member Firms that are developed and priced with M Carriers using M's experience data—have ever had in-force COI increases. With persistent environmental challenges, including low interest rates, M remains diligent in monitoring experience and advocating for policyholders.

These recent increases in COI charges have generated criticism from policyholders, distributors, and even the media, due to their historical uncommon practice and on account of COIs being most associated with mortality experience, which in general continues to improve.

A December 4 *Wall Street Journal* article on the COI increases ("Surprise: Your Life-Insurance Rates Are Going Up") included the following quote: "…a bigger problem is that many families bought universal-life policies' without understanding what the scope of the risk could be' from falling interest rates." This speaks directly to the important role Member Firms continue to play for our clients in educating them on insurance risks/opportunities and stress testing polices during the case design and in-force policy review phases.

M Financial Block of Proprietary Products

M Financial partners with select Carriers to develop and offer proprietary life insurance products priced with the segregated, superior experience (mortality, persistency, expense) of the ultra-affluent. Generally speaking, ultra-affluent clients live longer (mortality), keep their policies in force longer (persistency), and purchase higher face amount policies (expense) versus the general insured population and this experience often allows for better pricing and features. M proprietary products are issued by M Partner Carriers and reinsured with M Financial Re, giving M access to emerging experience/profits and providing M a "seat at the table" for the ongoing management of these policies. There are currently more than 30 M proprietary life insurance products available exclusively to M Member Firm clients.

M Financial believes that raising in-force policy charges is a decision with serious ramifications for both policyholders and insurance carriers that should primarily be used to protect carrier financial strength and preserve equitable treatment of policyholders. As a result, M Financial proactively works with Carriers to manage the proprietary block to ensure sustainability, including supporting actions to limit general account portfolio yield dilution by managing crediting rates, enforcing premium restrictions, and marketing separate account alternatives.

Additionally, M Financial diligently reviews the in-force block on an ongoing basis and has an in-force management principle of addressing potential emerging adverse experience characteristics, that deviate from expected, by removing a product and redesigning it for prospective policyholders. By integrating the emerging experience in a new product, in-force policyholders are protected from the challenges of the adverse experience.

As a result of this proactive management of the in-force proprietary block, there has been no need to raise policy charges on M proprietary products and no policy charge increases are being contemplated.

M Financial has maintained a strong in-force management track record in working with Carriers to pass on favorable emerging experience, an uncommon industry practice. To date, M has implemented 54 in-force price improvements (i.e., policy charge reductions) on 20 proprietary products resulting in approximately $200 million in cost savings for Member Firm clients.

Current Assumption Universal Life

Now let's set the stage for the COI increases by reviewing the products and environment that have led to these increases. The in-force COI increases have been applied to universal life (UL) policies, both current assumption UL and no-lapse guarantee (NLG), in a severely decreasing interest rate environment that has significantly reduced the insurance carrier portfolio yields supporting these policies.

Current assumption UL products provide non-guaranteed policy performance, based on insurance company experience, in the form of charges and credited interest applied to the cash value. As long as the cash value is positive, the policy remains in force. An increase in policy charges reduces the cash value and increases the risk of policy lapse (i.e., the policy being terminated for no value). Increased premiums or a reduction in face amount can help keep the policy in force when charges increase.

UL is transparent, with the policy contract and most illustrations providing the detail of the charge and interest credit structure. Charges are typically applied as follows: percentage of premium, a flat dollar amount, per $1,000 of death benefit, asset based (basis points on the underlying cash value), and a cost of insurance. The cost of insurance is a rate applied to the net amount at risk (face amount less cash value).

The credited interest is also disclosed, with the crediting rate being applied to the cash value.

UL products are priced with the charges and crediting rate based on the insurance carrier's current experience for mortality, investment income, expenses, and persistency. The charges and crediting rate are not guaranteed and may be changed by the insurance carrier to reflect emerging experience, a provision disclosed in the contract.

UL contracts include guaranteed maximum charges and a guaranteed minimum crediting rate. Current charges may not exceed the guaranteed maximum charges and the current crediting rate may not be less than the guaranteed minimum crediting rate.

It is important to note that insurance carriers price UL products with the complement of charges and a crediting rate supporting all experience elements. For example, while the carrier's portfolio yield primarily supports the crediting rate, the pricing interest spread (difference between portfolio yield and crediting rate) may also support carrier expenses and provide profit.

"Cost of Insurance" (Not Just a Mortality Charge)

A key component of the discussion is an understanding of what the COI charge actually represents. The COI charge, while primarily applied to support insurance carrier death claims (i.e., mortality experience), also provides recovery for carrier expenses, profit, and interest spread (e.g., the pricing interest spread

may be reduced by increasing COIs and vice versa). As a result, the charge is called "cost of insurance," not just a mortality charge. This point also applies to many policy contracts with COI language/terminology being used in place of "mortality."

No-Lapse Guarantee Universal Life

Some of the charge increases involve NLG products. In these instances, charge increases only impact the cash value and do not impact the death benefit guarantee. Because NLG is often purchased for the guaranteed death benefit and typically has low to minimal cash values, it is unlikely that raising charges for NLG products will drive a need to replace the policy. Also, NLG typically has minimal cash values, which may preclude 1035 opportunities into potentially better performing products and limit flexibility and value to the policyowner if a need to access cash emerges.

Whole Life

While the charge increases referenced above only apply to UL products, whole life (WL) products may also be subject to increased charges via the non-guaranteed dividend.

WL has the same underlying fundamentals of UL—interest credited and charges deducted based on current experience for interest earnings, mortality, expenses, and persistency. However, unlike UL, WL mechanics are not transparent, fueling the use of the term "black box."

UL starts with current assumptions based on current experience; the charges can be changed (but no worse than the guaranteed elements) as emerging experience changes. WL starts with conservative guaranteed assumptions, and then may provide credits in the form of dividends based on emerging experience that is better than the guarantees.

It is difficult to determine if the charge component within the WL dividend has been increased or decreased as dividends are not transparent. Further, mutual companies typically only communicate changes in dividend interest rates (DIR), which may or may not be impacted by mortality and expense experience.

DIRs may be considered misleading as they are not crediting rates and are calculated differently from company to company. Therefore, they are difficult to understand and should not be compared. There are examples of DIRs being maintained while the underlying charge component within the dividend is increased. Therefore charge increases have also been applied to WL products but the black box non-guaranteed nature of dividends makes it easier for mutuals to implement the increases without any policyholder or media scrutiny.

As shown below with the historically declining interest rate environment and resulting lower insurance company portfolio yields and UL crediting rates, DIRs have also generally been declining. For more information on DIRs, please refer to the July 2015 M Intelligence piece *Dividend Interest Rates for 2015*.

But one thing is the same for both UL and WL. Ongoing policy performance reviews should be performed regularly with a discussion of options for potentially better performing new products.

Regardless of the external factors impacting product charges, ongoing, transparent conversations are essential components of successful client relationships.

Variable Universal Life

Variable universal life (VUL), another life insurance product type, has not been impacted by the COI increases. VUL is similar to UL in that it has transparent product charges, including COIs, and interest credit; VUL, like UL, also remains in force as long as the cash value is positive.

There are also differences. Instead of crediting interest on premiums, VUL premiums are allocated to the separate account with multiple options of equity and bond mutual funds offered by the insurance company. The funds, which can increase or decrease in value, may either be managed by the insurance company or by outside fund managers. The policyholder determines how the premium is allocated among the offered funds.

Perhaps the most significant difference between UL and VUL is that the use of separate account funds in a VUL product provides 100% risk transfer to the policyowner. There is no guaranteed minimum crediting rate (however, like UL, VUL charges are also subject to guaranteed maximums). For example, if a fund selected in a VUL policy returns 30%, the cash value is credited 30%; if the fund has a loss of 20%, then the cash value is credited with a negative 20%. With 100% risk transfer to the policyowner, the insurance company is able to maintain its interest spread and avoid the need to raise COIs on VUL products (assuming no adverse mortality experience).

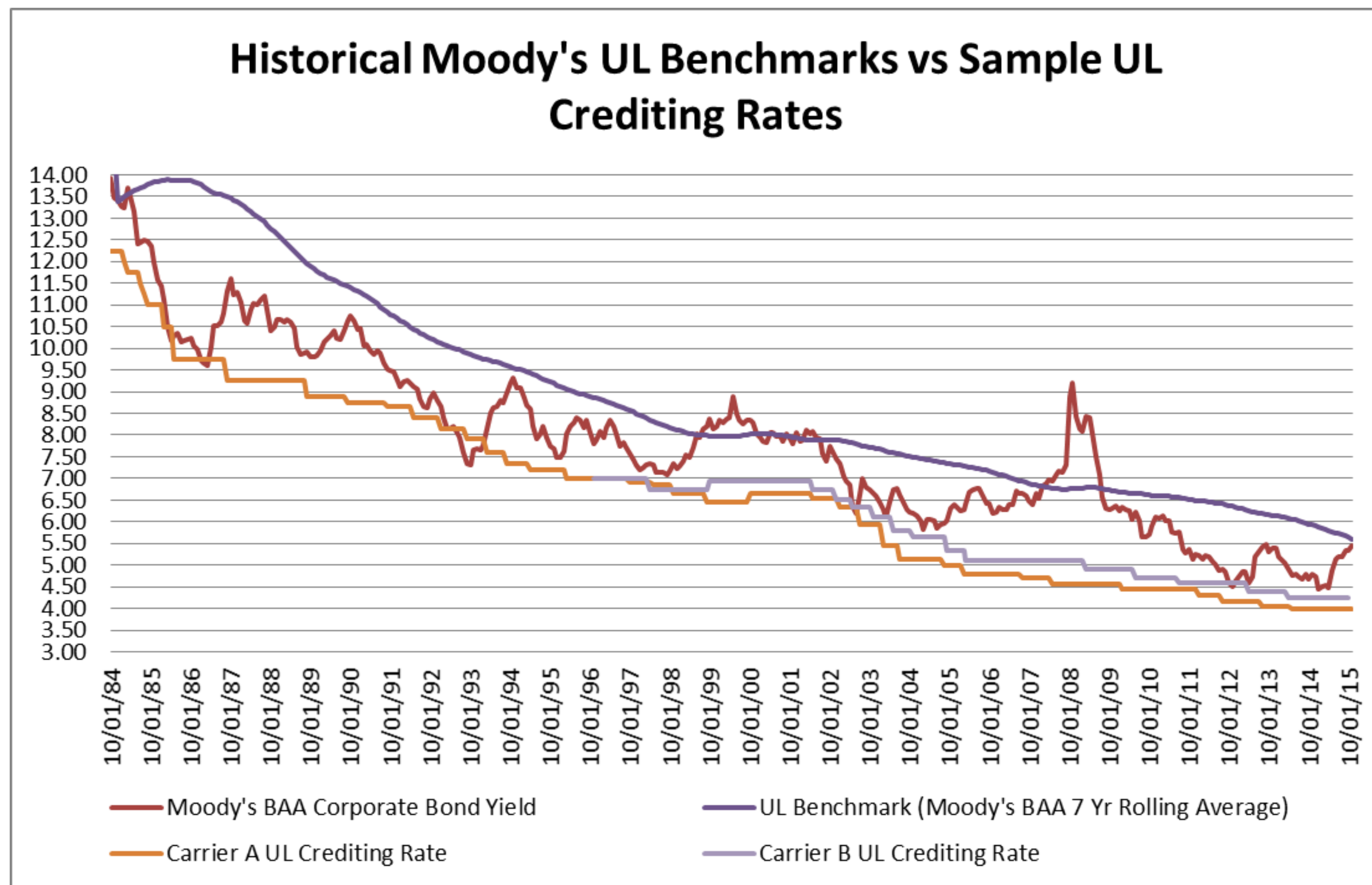
Of note, many VUL products also offer general account options with guaranteed minimum crediting rates. However, general account allocations within VUL policies are limited (typically to significantly less than 50%) with a majority of the premium being allocated to the separate account.

Historically Declining Interest Rate Environment

Typically, more than 80% of insurance carrier asset portfolios supporting UL crediting rates (and WL DIRs) consist of investment-grade bonds and mortgages within the general account. Interest rates have been generally declining for the past 30+ years, putting downward pressure on portfolio yields and leading insurance carriers to lower crediting rates in order to maintain pricing interest margins.

See Figure 1. The Moody’s Baa Corporate Bond yield, a new money rate, represents a typical insurance carrier investment and the 7-year rolling average represents a proxy insurance carrier portfolio yield with assets turning over with time. The decline in interest rates and portfolio yields has been dramatic—interest rates were in the 12–14% range in the early 1980s and are now in the 4–5% range.

Figure 1: Historical Interest Rates



Historically, insurance carriers have generally been able to maintain their priced-for-interest margins by lowering crediting rates; however, guaranteed minimum crediting rates on the older blocks are in the 4–5% range (higher than in newer blocks), so lowering crediting rates further is no longer a viable option.

As interest rates have declined, insurance carriers have lowered guaranteed minimum crediting rates. In general, products issued in the 80s have guaranteed minimum crediting rates in the 4–5% range, 90s-issued in the 3–4% range, and 2000s-issued in the 2–3% range.

As of today, insurance carrier portfolios are earning approximately 5%. Therefore, older products with guaranteed minimum crediting rates in the 4–5% range may not be covering priced-for-interest margins, as products are typically priced with interest spreads in the 25 to 100+ bps range.

Reduced Insurance Carrier Profitability

Depending on the product and premium funding levels, interest margins can provide more than 50% of the total insurance product profit sources (i.e., interest margins are significant factors in product pricing and profitability).

With lower interest margins and resulting lower profits, insurance carriers may be exposed to declining financial strength and claims paying ability.

Rating agencies have expressed concerns with the low interest rate environment and have recently provided the following commentary:

- Moody's Comment (December 10, 2015)—Prolonged Period of Low Interest Rates Pressures Reserve Margins
  - "In Q3 2015, both industry net income and net operating income declined over the same quarter a year ago, primarily driven by low interest rates. Over the past several years, interest rate rebound projections have proven premature. A continuous period of low rates over a long period would subject insurers to substantial losses due to significantly lower investment income, higher statutory reserve requirements, and meaningful DAC write-downs on GAAP financials. This scenario would result in weakened profitability, capital adequacy and financial flexibility."
  - "Due to inadequate investment returns combined with contractual guarantees based on too-high expected returns, several companies added statutory reserves because of deficiencies in their margins of reserve adequacy under the decreasing interest rate scenarios. Given the ongoing low rate environment, we would expect reserve margins to continue to decline at year-end 2015 and for more reserves to be added."
- Fitch Comment (December 10, 2015)—Stable Outlook for U.S. Life Insurers in 2016
  - "These positive factors somewhat mitigate Fitch's ongoing concerns over persistent low interest rates that will continue to pressure interest margins and reserve adequacy in 2016. Fitch expects continued earnings pressure in 2016 due to reduced interest margins, which will offset modest growth in fee and underwriting income."

Mortality Also Driving COI Increases

In addition to lower portfolio yields, Banner and William Penn, AXA, and Voya have also attributed the COI charge increases to adverse mortality experience. Voya specifically mentioned older age mortality and Banner and William Penn mentioned conversion segments with policyholder anti-selection. Voya also referenced rising reinsurance costs as premium rates have been raised on mortality risk ceded to reinsurers.

M believes the primary driver of COI increases is lower interest margins. When repricing products, however, carriers are also taking an opportunity to tighten mortality pricing in light of emerging experience, particularly for older ages where there has, to date, been less credible experience. M believes most carriers will tighten up their mortality pricing for new business only, leaving in-force COIs alone unless they can't manage profits through interest margins (i.e., when current crediting rates are at the guaranteed minimum).

Insurance Carrier Options to Manage Declining Profits

When there is downward pressure on interest margins due to lower portfolio yields and crediting rates are already at the guaranteed minimum, options are limited and it is challenging to preserve equitable treatment among all policyholders.

- Insurance carriers have been struggling with lower interest margins for some time and most have chosen to stand pat with the expectation that new money rates will eventually rise. As new money rates have remained low, insurance carriers are finding it more difficult to hold the line.
- A less visible, yet commonly deployed, approach is to manage profitability across all products (instead of product by product). Newer products (better interest margins and crediting rate flexibility; not at the guaranteed rate) can, to a certain extent, subsidize the older products at the guaranteed minimum. In practical terms, crediting rates on newer products are somewhat lower versus if there was no subsidization. Taking it to the extreme, recently a carrier reduced current crediting rates to the guaranteed minimums for all products, including newer products with much lower guaranteed minimum crediting rates.
- Another option, which has been the least commonly used and raises the most concern, is to increase policy charges on the specific products where interest deficiencies are occurring.

Regardless of the option implemented, some combination of players—insurance carriers, in-force policyholders, new policyholders—pay the price.

M believes that when managing profitability issues, it is important for insurance carriers to stand behind their products and take proactive steps to manage in-force blocks to mitigate profitability issues before problems arise. And while increasing policy charges on in-force policyholders may be contractually allowed, the action can harm clients, may not be consistent with their expectations, and may compromise their underlying confidence in our products and our industry.

Insurance Carriers are Reluctant to Raise Policy Charges, Including COIs

Even with significant reductions in profits, and contrary to skeptical policyholders and members of the media, most insurance carriers are reluctant to increase policy charges for the following reasons:

- Increasing policy charges comes with reputational risk as well as the potential for a significant negative impact on future sales. Criticism of the recent charge increases has been loud and future policyholders may not want to purchase a policy from a carrier that has a track record of raising in-force policy charges. Insurance companies that have a goal of increasing life insurance sales are likely to view policy charge increases as a last resort.
- By raising policy charges, the carrier may motivate healthy in-force policyholders to seek new products from different carriers and possibly 1035 their policies into better performing products. This leaves the carrier with a block of policies on impaired lives with higher resulting death claims. By fixing the interest spread issue with a policy charge increase, carriers could create customer defection today and a mortality experience issue tomorrow.

While Not Constrained by Regulatory Approval, Insurance Carriers May be Limited by Policy Contracts

Insurance carriers are not currently required to seek regulatory approval for increasing life insurance policy charges (subject to the guaranteed maximum charges). The right to increase policy charges is set forth in the contract and disclosed to the policyholder. In addition, an informational filing is also not required.

However, insurance carriers may be constrained by policy contract language. In 2008, Conseco raised COI charges and was subsequently sued. The court ruled against Conseco, finding that because the table

setting forth the maximum charges was titled “Guaranteed Maximum Monthly Mortality Charge,” the contract used “interchangeably” the terms “cost of insurance rates” and “mortality charge,” reflecting that the insurer “considered the terms at least connected, if not interchangeable.” The potential for policyholder confusion was enough for the court to rule against the carrier.

In the wake of the Conseco lawsuit, carriers have taken steps to review current contract language, confirm with filing consultants, and tighten contract language, specifically stating that COI charges may be raised for multiple reasons: mortality, expense, interest earnings, profit, etc. However, this revised language would apply to new products with lower guaranteed minimum crediting rates and therefore it is unlikely interest spread deficiencies are driving a need to raise charges.

Policies with the greatest risk of COI increases (i.e., policies issued approximately prior to 2009 with guaranteed minimum crediting rates in the 3–5% range) have the possibility that some of those contracts may limit COI increases to mortality only. However, based on M Carrier feedback and in looking at the contracts for the proprietary products, our analysis suggests the majority of older contracts were silent and did not tie COIs directly to mortality only, thereby allowing the Carrier to legally raise COI charges to cover interest margin deficiencies. See sample wording below from Pacific Life’s first UL product introduced in 1984. Note there is no mention of “mortality” instead using “Insurance Charge” language.

Cost of Insurance—… the non-guaranteed monthly cost of insurance rate will be determined by the company. This cost will not exceed the guaranteed amounts shown in the Table of Insurance Charges and any supplements to it.

Due Care Guidance and Considerations

All in-force products—those where policy charges have been increased and those where policy charges have remained the same and those where the crediting rate is at or near the guaranteed minimum crediting rate (or not) should be periodically reviewed for current performance. It is a best practice to advise clients on potential actions to manage risk and enhance performance, including a review of 1035 opportunities into a better performing product.

The economics of all options and current policyowner risk/reward attributes, health, financial goals, and means will drive the best solution. The suggested steps outlined below provide a framework to analyze policies and provide potential solutions to clients with policies that have already experienced charge increases and those at an elevated risk for future charge increases.

Products with Charge Increases

- Review in-force illustrations
    - Determine duration of policy lapse with current premium schedule and current face amount
    - Determine amount of additional premium to maintain the death benefit
    - Determine amount of face reduction with no additional premium
- Review 1035 options

  - Insured health and underwriting offers will drive whether or not this option is available or economically feasible
  - New underwriting and reentering select COI period may help new policy performance
  - Consideration should be provided for new incontestable and suicide clauses (typically two years)
  - New policy performance will need to overcome new issue loads and resulting lower early cash values
  - 1035 to a UL policy
    - Consideration should be given to the lower guaranteed minimum crediting rates in the 2% range and carriers continuing to lower current crediting rates due to continued portfolio yield dilution
    - Run downside scenario illustrations with lower crediting rates by 25 to 100 bps and at the guaranteed minimum crediting rate
    - Consideration should be given to the current policy which has a higher locked-in guaranteed crediting rate and a lower risk of another round of charge increases versus the new product where the current crediting rate is likely to continue to decrease (i.e., is a new policy with lower charges and a lower guaranteed minimum crediting rate better than the existing policy with increased COI charges and a higher guaranteed minimum crediting rate?)
  - Into IUL or VUL with potential upside performance
    - Determine crediting/earned rate to match performance on current policy and is that rate acceptable from a risk and opportunity perspective
    - IUL is most likely a better replacement for UL due to downside protection with a 0% floor and may be able to include an NLG rider for more protection (at a cost)
  - Reduce risk by moving to NLG
    - Premium and death benefit now guaranteed
    - Review premiums and death benefit that can be supported with the exchange
    - Consider resulting lack of cash value and resulting reduced future policyholder flexibility
    - Consider no upside potential for policy performance
    - Consider premium timing risk and ongoing policy management to ensure the guarantee remains on track
- Review Policy Surrender and Life Settlement Options
  - These may be legitimate options if there is no longer a need for the death benefit
  - Tax consequences should be reviewed
    - For a policy surrender, income tax is applied on the amount in excess of the policyholder's basis, which is equal to the aggregate amount of premiums paid less the aggregate amount received under the contract that was not included in the recipient's gross income (e.g., nontaxable dividends, which are essentially the return of excess policy premiums).
    - For a life settlement, income tax is applied on the amount realized less the policyholder's adjusted basis in the contract. The determination of the policyholder's adjusted basis, however, is not entirely clear. The adjusted basis may be the policyholder's basis for a policy surrender, as described above.

However, according to PLR 9443020, the IRS stated the basis in a life insurance policy that is sold (as opposed to being surrendered or redeemed under IRC § 72(e)(6)) should be reduced by the cost of insurance protection provided through the date of the sale and any amounts (e.g., dividends) received under the policy that have not been included in gross income. As a result, the proper treatment of the amount received by a policyholder(s) in a life settlement (i.e., where the policyholder is not terminally or chronically ill) may not be resolved definitively until this issue is squarely addressed by the IRS or a court.

Products with Potential Exposure to Charge Increases

Products at or near guaranteed minimum crediting rates may be at risk of an increase in policy charges. Products may contain non-guaranteed persistency bonuses or dividends which the carriers can also lower to manage interest margins and reduce exposure to having to raise policy charges. The review process described above for policies that have had charge increases will also apply here.

Other considerations include:

- Raising policy charges is still uncommon and there has been a reaction to the limited action within the industry, among policyholders, and in the media. Carriers will remain reluctant to raising charges.
- Review the policy contract to see if the carrier has the contractual right to raise charges; M believes most contracts will allow for COI increases for factors other than adverse mortality but some older contracts may be limited to mortality only.
- Consideration should be provided to the current in-force policy with a crediting rate that is being protected with a higher guaranteed minimum in the 4–5% range; contrast to a new policy with a lower guaranteed minimum in the 1–2% range and ongoing pressure to lower crediting rates due to continued portfolio yield dilution; run downside crediting rate illustrations for the new policy to asses risk.
- Subject to insured health, the option to 1035 remains if charges are eventually increased.
- Proactively communicate with policyowners regarding risk/opportunity and options.

December Fed Fund Rate Increase and Impact on Carrier Portfolio Yields and UL Crediting Rates

On December 16, the Federal Reserve, as was widely expected, approved a quarter-point (0.25 percent) increase in its target funds rate. The new target will go from 0 percent to 0.25 percent to 0.25 percent to 0.5 percent. This is the first Fed fund rate increase in more than seven years and while this is good news for banks and insurance carriers, it will not have an immediate and dramatic impact on carrier portfolio yields and UL crediting rates.

- Fed officials made it clear, as noted in post-meeting documents, that the pace of increases will be gradual and dependent on the quality of economic data. The *Financial Times* polled 51 top economists on how fast they think the Fed would raise rates in the next two years. The median projection is for the Fed to lift rates by 75 basis points in 2016 and a further 100 basis points in 2017.

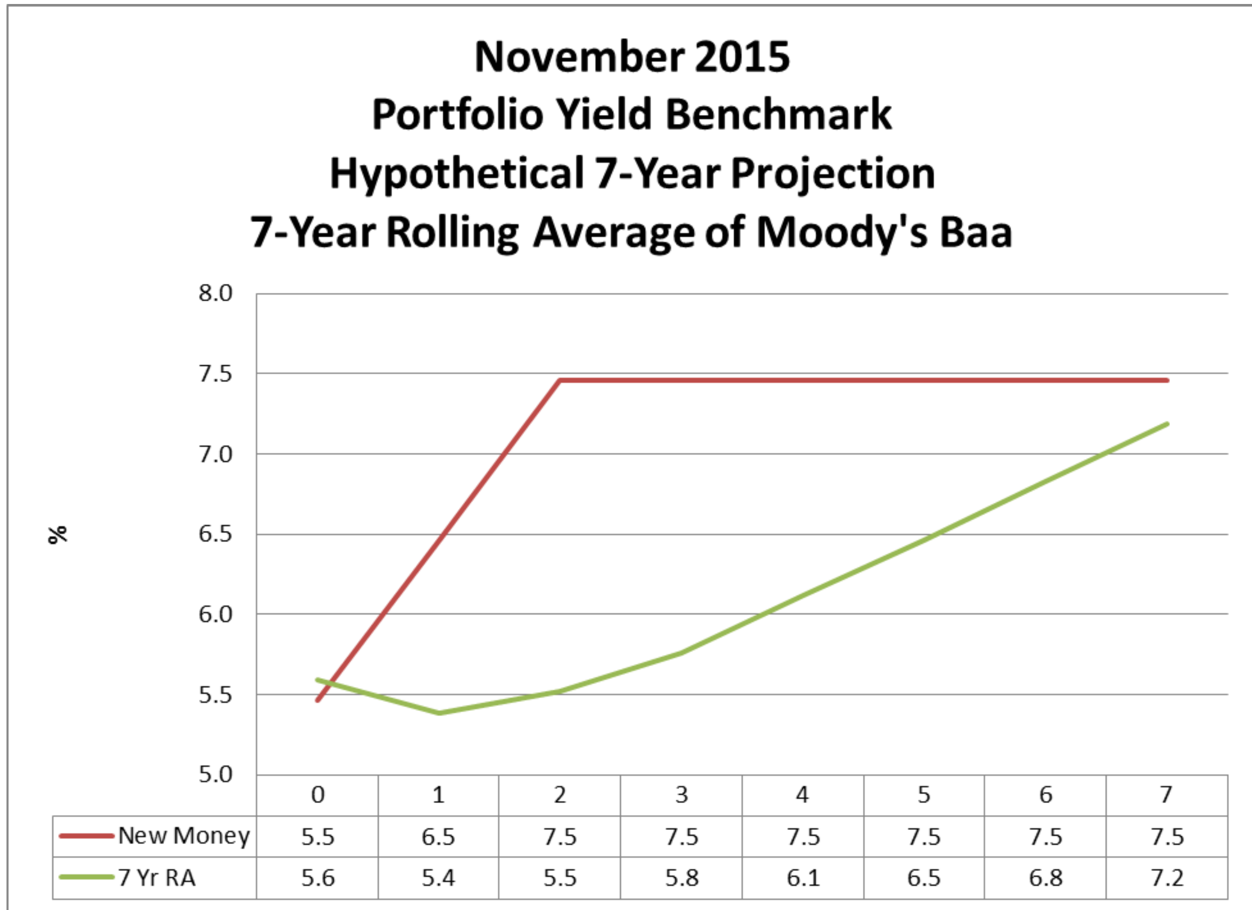
- As discussed earlier, insurance carriers primarily invest in corporate bonds and mortgages. Corporations can set their own bond rates, without directives from the Fed. In practice, however, a corporation that wants investors to buy its bonds sets a rate that is higher than the Fed target rate. There is no exact formula for this. The rate depends on the financial health of the company, plus the market's perception of what a fair bond rate would be in exchange for taking on the risk of buying the company's bonds. So it will take time to see the resulting impact of the Fed fund rate increase on corporate bond rates.
- The bond market is forward-looking, and because the Fed had all but confirmed the increase would happen by year end, the rate increase was priced into the market before the Fed made their announcement. Corporate bond rates have already increased approximately 90–100 bps in 2015, which demonstrates the forward-looking nature and the many different factors that impact bond rates (not just changes in the Fed fund rate).

The main takeaway is that portfolio yields will most likely continue to decline as portfolio yields lag new money rates and new money rates continue to be below portfolio yields (approximately 25–50 bps as of today).

An estimated projection of changes to insurance carrier portfolio yields can be calculated by using a proxy portfolio yield benchmark. A proxy benchmark is the 7-year rolling average of Moody’s Baa Corporate Bond Yield. This benchmark reflects the turnover of assets over time and the slightly lower quality and longer duration of assets that insurance carriers have trended towards in order to pick up additional yield. For the projection, we will assume an optimistic scenario where new money corporate bond rates increase 100 bps per year over the next two years.

See Figure 2. This projection shows that portfolio yields will continue to decline for the next year until they begin to rebound and will not exceed today’s level until three years out. Consequently, even under this optimistic projection, insurance carriers will not realize any relief from today’s squeezed interest margins for at least another three years.

Figure 2: Insurance Carrier Hypothetical Portfolio Yield Benchmark Projection



This analysis suggests insurance carriers will continue to be under pressure to recoup lost interest margins. Specifically, this projection shows that portfolio yields will continue to decline for the next year before rebounding, will not exceed today's level until three years out, and will not get back to a historical norm of 7% until seven years out. Of note, with the Fed action and general consensus that new money rates will continue to increase gradually, insurance carriers may be more willing to be patient and live with suppressed interest margins knowing that it may be temporary. Again, the rate increase is positive overall but will take time to provide relief for insurance carriers.

Conclusion

In any industry, price increases are rarely, if ever, viewed positively by clients. The life insurance industry is no exception. Recent policy charge increases have raised concerns, but they also serve as a reminder of the importance of client advocacy, including annual reviews, ongoing assessment of client objectives and new product offerings, and commitment to transparency.

M Financial believes that within the industry overall there may be continued exposure to carriers raising in-force policy charges in light of declining portfolio yields and adverse mortality experience. However, in M's discussions with M Carriers, there has been no indication of a need to raise in-force policy charges. M management is not aware of any imminent charge increases, retail or proprietary.

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Most policy contracts have terms that allow COI rate increases whenever some combination of investment, mortality, persistency, and expense experience significantly erodes profitability. Policy charge increases may only be used to restore future profitability and cannot be used to recover historical losses.

All in-force policies should be reviewed for current performance with a focus on potential actions designed to maintain life insurance goals. This review should include consideration of a policy replacement into a potentially better performing product. In-force products with current crediting rates at or near guarantees may have more risk for potential charge increases but should not automatically be replaced. Normal due diligence (risk assessment, product evaluation, client health, etc.) is required and heightened attention should be provided for the higher in-force guaranteed minimum crediting rate products versus a lower guarantee in a new product.

M believes carriers should proactively manage policy blocks on a sustainable basis. Carriers spend considerable time evaluating the impact, both positive and negative, of in-force charge increases and M will continue to encourage a thoughtful evaluation process where policy charge increases are considered primarily in the context of protecting carrier financial strength.

Regardless of carrier actions and external economic factors, M's commitment to client advocacy, as demonstrated by the 54 in-force improvements on 20 proprietary products and no COI increases to date, will continue.

Please contact Wayne Tonning (wayne.tonning@mfin.com) with questions.

This information has been taken from sources we believe to be reliable but there is no guarantee as to its accuracy. This material is not intended to present an opinion on legal or tax matters. Please consult with your attorney or tax advisor, as applicable.

Variable life insurance products are long-term investments and may not be suitable for all investors. An investment in variable life insurance is subject to fluctuating values of the underlying investment options and it entails risk, including the possible loss of principal. When redeemed, units may be worth more or less than their original value.

Variable Universal Life insurance combines the protection and tax advantages of life insurance with the investment potential of a comprehensive selection of variable investment options. The insurance component provides death benefit coverage and the variable component gives you the flexibility to potentially increase the policy's cash value.

Death benefit guarantees of variable life insurance products are subject to the claims paying ability of the insurance company.