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UNDERSTANDING RECENT COI INCREASES

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COI Charges have historically been an uncommon, or even untouched, 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, in 2015 and 2016 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 and any secondary no-lapse guarantees have remained intact, this break in tradition and the materiality 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 2%, 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 guarantee, 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.
- A basic tenet of managing life insurance reserves is asset-liability matching; the long duration promise of Life insurance is backed by long duration assets. Normally, the longer the duration the higher the yield. The past decade has seen little, sometimes a negative, return for long duration investment forcing some carriers to select short duration assets and "hope" the yield curve normalizes in the near future, which also has not occurred.
- Aside from increasing investment in riskier assets (that may have quality and liquidity risks) 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, such as the following:
Higher Cost of Mortality

- Despite medical advances and increasing life expectancies, some carriers are experiencing negative mortality which seems counterintuitive until one realizes that carriers often assume mortality improvements in pricing, especially from the insured population.
- When actual death claims are worse than assumed, mortality costs can exceed what a policy was priced to support.
- Lower cash values as a result of reducing crediting rates can result in more net amounts at risk (death benefit minus the account value) and amplify any negative mortality effect.
- Some carriers may use investment spread, as described above, as a pricing element to help cover mortality costs, along with actual COI Charges (the "Cost of Insurance" can include more than mortality rates). For example, a carrier can trade lower COI Charges for a higher spread (lower crediting rate) or vice versa. Lower spreads may further fracture the relationship between pricing assumptions and actual mortality costs.

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Higher Reinsurance Costs

- Reinsurers are insurance carriers for insurance carriers. If a death claim is paid by the primary carrier, the reinsurer reimburses it for the amount ceded. Reinsurers charge the carrier a premium in exchange.
- Increased reinsurance costs, perhaps due to adverse mortality experience causing reinsurers to pay out more claims themselves, can increase the cost of mortality for the ceding carrier.
- The market for reinsurance is not as favorable over the past decade. Lower competition resulting from fewer players gives the big, consolidated players leverage and driving up the pricing for carriers.

Lower Lapse Ratios (Higher Persistency)

- A carrier that experiences lower lapse ratios than originally assumed in pricing certain policies may incur more death benefit liabilities than what those policies were priced to support.
- The rise of the life settlement market where investors buy policies from their original owners and hold them until the insured dies to earn a return may be a contributing factor to this issue.

Adverse Premium Payment Experience

- Many policy owners take advantage of the premium flexibility of Universal Life by paying artificially low premiums "now" and higher premiums "later", resulting in the carrier receiving less premium in the short term and creating a negative time value of money effect that can magnify adverse investment and/or mortality costs.
- This type of premium behavior is often practiced by life settlement companies looking to maximize return on their investment in the policy, possibly coupling this pressure with that of lower lapse ratios described above.

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 or necessity to consider raising COI Charges. When interest rates rise to normal levels resulting in healthier investment earnings, depending on the extent to which this occurs, 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 are the non-guaranteed elements of a life insurance policy that can change?

Universal Life (UL)-Type Policies

- Guaranteed policy factors are stated in the contract and include the maximum policy charges, including COI rates, premium loads and administrative expenses, as well as the minimum interest crediting rate.
- Non-guaranteed factors include the current COI rate scale and other current charges, below the maximums, and current declared crediting rate (or cap and participation rates with Indexed UL), above the minimums.
- COI rate factors naturally increase over time to account for the increased risk of death in any given year as the insured ages. An "increase in COI Charges," as discussed herein, does not refer to these naturally increasing rates but, rather, an upward shift in the COI rate scale itself.
- Adverse changes in COI Charges or crediting rates may cause the premium required to maintain coverage (beyond any secondary guarantee period) to increase, depending on prior funding and performance.
- The extent to which COI Charges can be increased is typically dictated by the policy contract itself.
- In a "single consideration" contract, any change in COI Charges must be based solely on the carrier's "expectation as to future mortality experience"; the most narrow scope of carrier discretion in this regard.
- In "multiple consideration" contract, changes in COI Charges can be based on a number of considerations, which are often listed as being non-exclusive, and typically include "expectation as to future mortality, lapse (persistency) expense and/or investment income expense"; an increased scope of carrier discretion.

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- In a “silent consideration” contract typically states that the carrier has discretion to change COI Charges without identifying the factors or considerations; the broadest scope of carrier discretion.
- In most cases, approval of the applicable state insurance regulator is not required to change COI Charges.

Whole Life (WL)-Type Policies

- The implicit crediting rates and COI Charge elements are built in to a “base” schedule of cash value and premium, both of which are guaranteed.
- The primary non-guaranteed element of a WL-type policy is the annual declared dividend, which can be used to purchase additional coverage (increasing death benefit and cash value), reduce premiums, paid in cash, etc. Non-guaranteed dividends, therefore, are a key buying consideration at issue.
- Carriers have the discretion to reduce the dividend and affect the profitability of WL blocks by adjusting the investment, mortality or expense components of the dividend scale. Reduced dividends can result in more out-of-pocket premium, less long-term death benefit and less cash value than what was planned at issue.
- Dividend changes typically do not require state insurance regulator approval.

Risk management tips

Review a carrier’s historical changes that it has made to non-guaranteed elements of in-force blocks of policies. Obviously past performance is no guarantee of future results but it can certainly provide some insight on the carrier’s track record for pricing and managing non-guaranteed elements.

Pay attention to public comments by senior leaders at carriers, such as on 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 made a press release in which it announced that, at the present time, it does not intend to raise any COI Charges.

Conducting annual policy reviews by requesting in-force illustrations and comparing 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: Reduce 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 any required adjustments to meet long-term goals are cost prohibitive, 1035 exchange the policy to an annuity, surrender 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); and
- 47% say their insurance agent had never recommended to review the performance of their policy.

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As of 2014, according to the Elder and Special Needs Law Journal (Winter 2014, Vol. 24, No. 1), further reinforces a 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, such as COI Charge increases.

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