Is My Life Insurance Policy Protected?

The life insurance industry has in place a safety net of conservatism, regulation and oversight that, in these challenging economic times, may not be readily apparent. This document explains the many different safeguards that are designed to protect insurance consumers and help ensure insurance companies can pay the claims of their policyholders.

How is the life insurance industry regulated?

While there are some federal laws that affect life insurance, it's regulated by the states. Each state has its own set of statutes and rules. State insurance departments oversee insurer solvency, an insurance company's ability to meet its financial obligations to you. They also review market conduct and rule on requests for health coverage rate increases, among other responsibilities. Although each state has its own set of statutes and rules, there are a number of areas where significant uniformity exists.The National Association of Insurance Commissioners (NAIC), a nonprofit organization that assists state regulators, develops model rules and regulations for the industry, many of which must be approved by state legislatures before they can be implemented. As with NAIC efforts, the advent of the Interstate Insurance Compact has moved state insurance regulation to even greater uniformity.

Due to Dodd-Frank, there is new uncertainty about the role of the federal government in the regulation of life insurance companies. At a minimum, it appears that a Federal Insurance Office will provide a high level federal presence in life insurance matters. In the future, an optional Federal Insurance Charter also may be available for carriers to opt out of state regulation, just as certain banks do today.

The fundamental reason for government regulation of insurance is to protect American consumers. The continued efforts of the state regulatory systems to strengthen their requirements and involvement in the industry to provide this protection have historically been successful. State regulators maintain tough financial standards for life insurance companies in a number of specific areas, including conservative policy reserves and accounting, minimum capital standards, and restrictions on general account investments. It is important to note that no life insurance policy has failed to pay 100% of any death benefit due.

In addition to state regulation, independent auditors review the financial statements of life insurance carriers for accuracy and conservatism. Although ratings agencies are not regulators, they also function as defacto regulators in the life insurance industry, impacting investment portfolios, earnings, and capital levels because of the importance of these external rankings.

What state regulations help ensure that my life insurance company will meet its obligations to me?

Each insurance company is responsible for maintaining liquid assets in amounts sufficient to pay suitably calculated liabilities (what is owed to its policyholders) associated with the life insurance policies that it sells.

When an insurance policy is issued, the company must set aside an amount of money, called a reserve, to be certain it will have money to pay the death benefit. Reserves are a bookkeeping entry, not really a separate vault of money.

The amount of the reserves held needs to be large enough to fund cash surrenders and death benefits.

The methods of calculating reserves are highly regulated by each state and are based on conservative interest and conservative mortality assumptions. These methods are quite consistent across most states.

In addition, life insurance companies are required to maintain a certain amount of overall capital and surplus (difference between assets and liabilities) in relation to regulatory benchmark levels.

Life insurance companies who have faced insolvency have been far more likely to have encountered asset problems (e.g., mortgages, junk bonds, derivatives) than liability problems (e.g., inadequate reserves).

What can state regulators do if a company is in danger of becoming insolvent?

State insurance regulators can take several actions to prevent an insurance company from failing:

Conservation

Conservation occurs when an insurance regulator takes over an insurance company's operations to conserve assets. One of the regulator's main duties is to conduct a thorough examination of the insurance company's books and records to determine whether the company can be rehabilitated.

Rehabilitation

Rehabilitation generally involves a regulator initiating a plan to return the company to a sound financial and operational condition. If efforts are not successful, then the state would place the insurer in liquidation.

Liquidation

The liquidation process ordinarily includes the seizure, marshalling and liquidation of a company's assets, and distribution of those assets to claimants with approved claims.

What happens when an insurance company becomes insolvent and is liquidated?

In practice, when an insurance company becomes insolvent, other life insurance companies that are headquartered or do business in the same state will rescue the faltering company through the state guaranty fund structure. The state's life companies can be involved by the state regulators to help with the bailout, but sometimes (especially if it's a small company that's in trouble), a larger company will take it over on its own initiative. A large company will be interested if the acquisition has a strong economic justification or if the acquisition provides access to new markets or distribution.

When a life insurance company becomes insolvent, state guaranty funds step in quickly. These guaranty funds continually collect state guaranty "assessments" from insurers licensed in the state, even before an insolvency occurs. This is similar to banks paying fees to the Federal Deposit Insurance Corporation. Such funds are then used to "rescue" policyholders. The individual state guaranty associations are members of a national association called NOLHGA (National Organization of Life and Health Guaranty Associations). There are limits on the amount of protection per policy that the state guaranty associations will provide a policyholder.

Policyholders of a failed company may face temporary limitations in access to the funds in their policy for some time, but the track record of payment is very strong. Historically, beneficiaries have recovered 100% of death benefits due them, and policyholders have been paid at least 90% of cash values due them.

How am I protected in the unlikely event that my insurance company fails?

Protection can be provided in one of several different ways. For example, a financially sound insurance company may take over the troubled company's policies and assume the responsibility for continuing coverage and paying covered claims. Claims from individual policyholders are given the utmost priority over other creditors.

Reinsurance is another mechanism by which policyholders are protected from insolvency. Prior to insolvency, a reinsurer takes some share of the risk from the direct carrier. After insolvency, a reinsurer often has many business reasons to want to step in and help support the direct carrier, perhaps by assuming a greater share of the liabilities.

In the unlikely event that there aren't enough assets to cover the claims, there is another safety net in place to protect you: state guaranty funds. These funds, which are used to help pay the claims of an insurance company that failed, are in place in all states. If an insurance company can't pay its claims, the guaranty fund will provide coverage, subject to certain limits, similar to the FDIC's coverage for bank accounts.

How did Life Insurers Fare During the Recent Economic Crisis?

Industry-wide, the life insurance industry fared relatively well during the recent economic crisis. Although there were a few well-publicized, attention-grabbing headlines, the conservative management and accounting regimes inherent in the U.S. life insurance business held up well to the difficult credit environment. The greatest challenges related to downgrading of mortgage-related securities, unrealized losses on fixed income securities related to widening credit spreads, lack of attractive pricing on Letters of Credit, and defaults/write-downs on assets backed by certain large investment banks. However, carriers have seen stability in their mortality experience, and expenses have been managed to react to the tight economy. Rating agencies have taken recent steps to lift negative outlooks on the life insurance industry, as capital and surplus levels have rebounded.

What does it mean when an insurance company holds assets in a separate account for me?

A separate account generally refers to an investment account used to manage the funds placed in variable insurance products (products that participate in the market, such as variable universal life or variable annuities). This account is maintained separately from an insurer's general account. In fact, state insurance law requires insurance company separate accounts to be held apart from the rest of the company assets.

Separate account assets are not subject to claims from any person or entity other than a contract owner, plan participant or beneficiary. That isn't the case with insurance companies' general accounts, where all assets are available to support contractual and other obligations of the life insurer. Another key point of distinction between a separate account and general account is that the separate account is accounted for by the life insurer at market value and the general account is typically

accounted for at book value. This provides an early indication if financial troubles exist on a market value basis. Separate account assets and liabilities are only relevant for the particular policyholders/insureds linked directly to those policies.

How would I be affected if the insurance company that issued my contract comes under new ownership?

Prior to an acquisition, when one life insurance company acquires another life insurance company, the buying company is required to honor any past and future guarantees made by the selling company in its policies. Provisions of the contract that are not guaranteed could be changed by the acquiring company, which can include decreasing crediting rates or increasing charges, but such changes can only be effective on a prospective basis. Many contracts contain obligations that are guaranteed, such as no-lapse guarantee products with guaranteed premiums, guaranteed interest crediting rates and charges. The acquiring company must honor these guarantees and can't alter the guarantees provided under the terms of the original contract.

Are life insurance companies rated?

There are several major rating agencies that provide opinions on an insurance company's financial strength to meet the claims obligations it made to you. They include: A.M. Best Co.; Fitch, Inc.; Moody's Investors Services; and Standard & Poor's Corp. Ratings are simply opinions, and they are updated periodically. Factors these agencies consider include: company earnings; capital adequacy; operating leverage; liquidity; investment performance; reinsurance programs; growth rates; diversity of business; management ability, integrity and experience. The rating agencies are generally consistent with each other, but not always so, in their relative ratings of insurers.

How important are ratings of life insurance companies?

Life insurance consists of promises you make to an insurance company (primarily to pay premiums) and promises the insurance company makes to you (mostly to pay the claim). Life insurance company ratings are one measure of the extent to which you can rely on a company to live up to those promises. If a company is financially sound, it's very likely to be able to pay the death claim or the cash surrender value (the amount of money you get if you cancel the policy) when it needs to.

If my life insurance company's stock price or ratings drop, does that mean it can't pay my claim?

Market forces and investor expectations drive share prices (how much one single share of a company's stock costs) of life insurance companies. Generally, share prices increase when investors believe future earnings will improve. As a policyholder, when you buy insurance, you aren't buying the stock of the company. You're buying a product that is backed by substantial reserves at a highly regulated insurance company. A declining share price doesn't mean that your coverage has suddenly deteriorated or that your insurance company can't pay its claims. A dramatic drop in the share price of an insurer could be the result'of many effects. A policyholder should be informed, and research and understand reasons for such an occurrence.

What are the Main Risks to Life Insurance Companies Today?

Although life insurance companies are exposed to risks at many levels, in today's environment, the major risks are those related to interest rate movements and older age mortality experience. In relation to interest rate movements, life insurance companies interestingly face challenges in the event of either interest rate decreases or increases. Further declines in interest rates create risks for insurance companies because many of the liabilities on their life and annuity contracts (both new sales and inforce) are fixed or are subject to guaranteed minimum rates of return. Life carriers rely on the ability to earn an investment spread in excess of the yields credited to policyholders. As their asset earnings rates decline, profits will fall unless there is a corresponding drop in contract Obligations.

On the other hand, a sharp spike in interest rates creates disintermediation risk for carriers. This means that existing policyholders will have incentives to replace their existing contracts with a new one that reflects the then-current, more attractive, interest rate environment. Aside from the negative impact of higher lapses on expense recovery, if insurers are forced to meet these increased redemption requests by selling existing assets, there could be realized investment losses. The most favorable interest rate environment for insurers may be one in which interest rates gradually increase in the future.

As the population ages and as life insurers target the Baby Boomer market, more and more life insurance and annuity products are relying upon pricing studies which reflect assumptions about older-age mortality (over ages 75). Unfortunately, there are only limited mortality studies of insured lives and annuitant lives at those ages. Estimates of future mortality improvement, the impact of cognitive testing, and the usefulness of prescription drug databases are all being made as part of the quantification of future mortality experience. These estimates often rely upon a continuation of past patterns seen in the general population to some degree. As the exposure and importance of advanced age mortality grows, insurance carriers will need to be vigilant in monitoring their experience and adjusting if it is unfavorable.

Other key risks that insurance companies face are the direction and volatility of the global equity markets (as they relate to contractual guarantees), supply of third party reinsurance, and new oppressive regulation.

Are Insurance Companies Using Hedging to Manage Risk?

A necessary core competency of a life insurance company is the ability to manage risk. Part of the risk management process is hedging, both implicit and explicit. Insurers implicitly hedge when they choose to balance their liability profiles with products that feature long-term liability cash flows as well as other products with shorter-term liability cash flows. Similarly, equity-based (stock market) products balance interest-based products, and products that perform well when mortality rises balance products that perform poorly in such a scenario. Further, some insurers hedge their distribution riSk, by seeking strong distribution partners across channels and across firms within the same channel. These are just a few implicit hedging examples.

Explicit hedges are those typically purchased in the financial markets. The most common forms of explicit hedging today involve the use of puts, calls options, and futures to support the equity-based guarantees made on variable annuity living benefits and index upside credits on fixed-indexed life insurance and annuity products. These hedges are designed to closely track the obligations provided by these contracts. Hedging strategies, such as the use of options, do involve risk and can have an adverse effect by magnifying losses.

Insurers have only mildly used macro hedging, such as hedging general market interest rate increases or decreases, that are not tied to specific policy liabilities. Such hedging may become more common in the future, as the value of many insurers' inforce books of business are very sensitive to future interest rate movements.

Finally, the investment markets have created securities called mortality catastrophe bonds ("cat bonds") and longevity bonds, which provide a means for life insurance companies to hedge broad population improvements or deterioration in mortality. This is a young marketplace, but one which is expected to gain in activity.

Are stock and mutual life insurance companies subject to the same state insurance regulations?

Yes. Products issued by stock and mutual companies are subject to the same scrutiny by state regulators with regard to solvency, including: minimum capital and surplus requirements, statutory accounting conventions, limits to insurance company investment and corporate activities, financial ratio tests and financial data disclosure.

Mutual companies are owned by their policyholders, and pay policyholder (shareholder) dividends. The amount of such dividends is regulated by the individual states. Mutual Holding Companies (MHCs) are a hybrid between a mutual and a stock company. MHCs are essentially mutuals with access to the capital markets.

Mutual insurers do report financial statements regularly, but such statements differ from those reported by stock insurers. As a general rule, mutual insurers are jess influenced by short-term earnings expectations. Further, stock insurers could be privately owned. Such carriers do not face the same shareholder reporting requirements as do publicly-traded stock insurers.

What happens to my policy if my insurance company is owned by a non-insurance company that becomes insolvent?

Life insurance companies that are part of a non-insurance company are separate and distinct legal entities called subsidiaries. Although insurance company subsidiaries are part of a larger company, they are responsible for the obligations associated with their contracts. For example, in the case of American International Group, Inc. (AIG), an insurance and financial services company that has faced ongoing challenges, the AIG insurer subsidiaries' assets are beyond the direct reach of AIG creditors. State and federal law requires insurers to be rehabilitated or liquidated in state courts. If AIG becomes insolvent, insurance commissioners and superintendents have broad power to protect policyholders by blocking sales of insurance company assets and wholesale movement of insurance company capital.

The main purpose of life insurance is typically to provide a death benefit. The appropriate policy for you is one that takes into account your needs and goals, has the potential to preserve your wealth during your lifetime and help you transfer the most wealth possible to your beneficiaries. Understanding how the money you dedicate to life insurance is protected can help you avoid fear-based or emotional decisions that could impact your financial future in the long term. If you have questions or concerns regarding the security or benefits of life insurance, contact your financial advisor.