Consumer Federation of America

Life Insurance Regulators Should Block Cost of Insurance Rate Increases When Used to Avoid Guaranteed Interest Rates in Universal Life Policies

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Several life insurers have indicated that they will be raising cost of insurance (COI) rate schedules on certain Universal Life (UL) insurance policies. At the least, AXA Equitable, VOYA Financial (formerly ING) and Transamerica have notified their agents of the action. (A review of the newsrooms of these three insurers in 2015 found no media press releases on this subject.) There are other insurers that have moved to raise COI rates or plan to do so, but it is not known how widespread the intent is. In general, life insurers in the past have resisted such increases fearing the risk of litigation and, no doubt, the risk of damaging the trust built up over decades with their agents and policyowners. While there have been occasional COI increases in the past, and there has been litigation on the issue, CFA is concerned that the actions taken may spread throughout the life insurance business. We urge state insurance commissioners to assure themselves that the increases are justified. We are concerned that COI rate increases will, in effect, void the interest rate guarantees in affected contracts. The question is: Are these insurers in a climate of low interest rates using COI increases to maintain profits when the interest rates they have been crediting to cash values have been reduced to the contractually guaranteed rates, often 4%, sometimes higher? Some background follows.

In a traditional whole life contract, a guaranteed level premium is conservatively calculated to cause the cash value steadily to increase to meet the guaranteed level death benefit at age 100 (age 121 in new contracts). The mortality risk each year is equal to the death benefit less the cash value (technically reserve). As the cash value increases the mortality risk decreases; the charge for it, a mortality rate increasing with age, is applied to a decreasing risk, the two policy components tending to offset each other.

In UL contracts the charge for the mortality risk is called a cost of insurance (COI) charge; it is equal to the COI rate that increases with age times the risk amount, the death benefit less the policy value (cash value before any surrender charge). If the death benefit is Option A, level, and if the level premium is sufficient, a UL policy will work in a manner similar to whole life. But many contracts sold in the 1980s and 1990s at times of high interest rates could be illustrated to last indefinitely at premiums lower than whole life. Many of these are failing or will soon begin to fail absent much higher interest rates.

Death benefit Option B is sometimes called Increasing; it is the original death benefit, called the Specified Amount, plus the Policy Value, the cash value after any surrender charge has terminated. Here we see the risk amount never decreases, unless the policyowner changes to Option A. The Option B COI charge is ever increasing, tantamount to buying increasing premium term life insurance to death, which no one does who wishes the policy to be in force at death. The writer believes few UL policyholders understand the significant differences between death benefit options A and B.

The UL concept was devised in the 1970s and became very popular in the 1980s, which was characterized by double digit interest rates. UL insurers, having little business in force that was issued before interest rates skyrocketed, could illustrate the future by assuming that current interest rates upwards of 10% would last indefinitely; they didn't have to pay 10% to many existing policyholders. This meant that agents could not only sell ostensibly lifetime coverage at low premiums when compared with whole life, but could use the high interest rates to lure whole life policyowners into replacing their existing whole life contracts. Upwards of 50% of UL sales in the late 1980s were replacements of whole life contracts, whose insurers had large portfolios of far lower yielding bonds and mortgages acquired in prior decades.

Inevitably, interest rates began a long term decline, as did the non-guaranteed interest rates UL companies credited. Here is the mid-year pattern from Mergent's (formerly Moody's) Corporate Bond Yield Average (CBYA) of long-term bonds averaged over the investment grades: 1988, 10.36%; 1993, 7.66%; 1998, 6.83%; 2003, 5.85%; 2008, 6.42%; 2013, 4.63%, December 2015, 4.58%. In late 2012 and early 2015, the CBYA dipped just under 4%.

<u>The UL industry's historical position on increasing cost of insurance (COI) rates.</u> As a result of evaluating hundreds of UL policies in the last 30 years - -see evaluatelifeinsurance.org – and general scuttlebutt, the writer is convinced that UL insurers, at least generally, have refrained from the increasing COI schedules. This reluctance was despite being under pressure in recent years from the long decline in interest rates.

In the early days of UL, from our recollection, a reference rate for interest rate assumptions in pricing memoranda that formed the basis of submissions of policy forms to state insurance commissioners was the 10-year Treasury: insurers planned to earn enough more than the 10-year Treasury, say 1% more, to be able to credit an interest rate consistent with the 10-year Treasury rate. In the late 1980s, the10-year Treasury rate was around 9%, and so were UL interest crediting rates. The trend of the 10-year Treasury was steadily downward throughout the 1990s remaining at or above 5% until the post-2001 recession period when it pierced the 4% level for some months. Between 2003 and 2008 it fluctuated generally between 4% and 5%. Since mid-2008, the 10-year Treasury has been under 4%, hitting a low of 1.65% in 2012; in mid-January 2016 it is about 2.2%.

The most common guaranteed rate in UL contracts sold in the 1980s and 1990s was 4%, with some insurers guaranteeing more but none, to the writer's knowledge, less. Obviously, UL insurers have been under pressure for some time to meet their 4% or higher guarantees for quite a while. One might ask, "What has taken these three insurers, at least, so long to make their moves? One source of additional margins has been steadily improving mortality experience. E.g., the writer has had a policy in Northwestern Mutual Life since 1986; it has improved the mortality portion of its dividend formula six or seven times in the last 20 years. That is the nature of mutual life insurers, owned by their policyholders: to pass through all earnings not needed for safety. UL insurers, for the most part, are shareholder owned, owing allegiance to their shareholders. I have never heard of UL insurers passing through mortality improvements, i.e., lowering schedules of COI rates. Some UL insurers must have, particularly those such as Pacific Life, Minnesota Life, and Thrivent, that operate in mutual holding company format. .

UL policies have explicit interest rate guarantees, typically 4% in mature contracts; they also have maximum, very high, COI rate schedules stated in every contract. A UL policyholder holding a contract whose current interest rate has been lowered to the minimum would reasonably conclude that increases in COI schedules to maintain or restore profitability voids the guarantee absent a demonstration that mortality of the block of policies has deteriorated profoundly, that is, is now running at mortality rates higher than the company's actuaries assumed when pricing the policies. That seems highly unlikely given steady mortality improvement, although one can imagine a UL insurer with high policy termination rates left with a much smaller block of business in poor health, since those who terminated, whether to transfer elsewhere or simply to cash out, were presumably in good health.

It is our understanding that UL insurers have refrained from COI rate increases unless they can demonstrate with an actuarial memorandum that the mortality of the relevant block of policies is higher than originally assumed.

<u>Table Shaving.</u> Even if the demonstration noted can be made, it should not be *prima facie* sufficient when the insurer engaged in the practice of granting an applicant a better health classification that the insurer's underwriting manuals and underwriters would normally grant because it is a large case, possibly having been shopped among several prospective UL insurers. Generally, health classifications in today's market are as follows, often with names designed to obfuscate, for a nonsmoker: Preferred Plus, Preferred, Standard, Table A, Table B, Table C, etc. Hence the name: Table Shaving.

An insurer proposing to raise COI schedules due to mortality experience on a block of business in excess of that assumed in its pricing of that block when it has deliberately underrated risks would surely be courting litigation.

<u>Are UL insurers deserving of relief from persistently low interest rates of recent years?</u> It does not take much imagination to imagine that millions of UL policyholders will be adversely affected if insurers are free to raise COI rate schedules. It will be adding insult to injury to those

policyholders who have been faithfully making UL premium payments only to find, without COI rate increases, that their policies are falling apart. See http://www.consumerfed.org/pdfs/Evaluate-June-2013.pdf, in which the writer tried to provide some assistance in this respect: *What Should I Do with My Failing Universal Life policy?*

Those sold UL policies in the 1980s and 1990s cannot be expected to have understood the history of interest rates in the U.S. But surely the actuaries and investment department executives knew that history, or should have known. They should not have countenanced the sales of underfunded UL policies, by which we mean those that could collapse before death if interest rates declined to historical norms, or even below, based on then current mortality experience. Predictably, such insurers will respond that every sale was accompanied by an illustration showing both guaranteed and non-guaranteed future values, and that the former usually showed policies terminating at some future date. That is a legal and contractual defense but is it sufficient?

It is said that life insurance is sold not bought. What percentage of UL agents would be careful enough to call attention to guaranteed values, thereby threatening their sales? On the contrary, what they call to attention is the high cash values at retirement ages based on current values illustrated into the future at historically high interest rates.

A UL Insurer's communication to its agents. The following was obtained in an Internet search for "COI increases." The insurer is not one of the three mentioned above. The document appears to be an excellent exposition of the company's justification for the increases, including specific FAQs directed toward its agents to help answer policyholder questions that we have omitted. See http://www.ubsnet.com/assets/Uploads/Newspdf/Banner-COI-Increase-7-22-15.pdf

1. Why did the cost of insurance (COI) rates increase on my policy? After the most recent review of the company's experience factors (mortality, persistency, investment income, and expenses), it has been decided that the company did not adequately account for future experience; as a result, the COI rates have been increased to reflect our new expected future experience.

- What does that mean? When the cost of insurance rates were originally set, the company had certain expectations for: the number and timing of death claims; how long people would keep their policies; how well the company's investments would perform; and the cost to administer policies. Based on our review of the company's recent experience, the company has revised future expectations for the experience factors.

- Why is that my problem? The policy contract allows increases in COI rates when there is a change in the company's future expectations, which is based on the company's expectations for mortality, interest, expense, and lapse experience.

- Why does that affect me? The changes to the cost of insurance rates have been applied on an equitable basis to all policyholders with a [market name of insurance product] policy, and will take into effect [date of increase].

2. Can the company legally increase my COI rates? Yes, according to the contract, when there is a change in expectations as to future experience, the company can increase the non-guaranteed/current COI rates to no greater than the guaranteed maximum COI rates shown in the policy schedule.

3. What does the COI rate increase mean to my policy? The COI rate increase will result in higher monthly policy charges, which causes the policy to underperform when compared to past illustrations. That is, if the policy owner continues to pay the current billed premium, the policy may generate less cash value and may maintain coverage for fewer policy years than previously illustrated.

Notice in the first two bulleted comments that the UL insurer asserts, in effect, that it is free to raise COI rates regardless of the source of the change in future outlook, whether "mortality, interest, expense [or] lapse." As the insurer guarantees maximum expense charges in the contract, it is at least questionable whether it could increase COI rates to cover a shortage in administrative expenses. Increased lapse rates would make a better argument as no insurer issues a contract guarantee of them. But each insurer guarantees a minimum interest rate, which for most UL buyers is the one policy detail, other than premium payments, that is understandable and often quoted by agents and policyholders.

Evidently, courts have disagreed on prior COI rate increases litigation but we are not aware that any contested action has focused on the questions we raise about use of COI rate increases to cover inadequate investment income to meet interest rate guarantees. Whether the arguments above would hold up in court is interesting to contemplate.

State insurance regulatory officials should require UL insurers to justify COI rate schedule increases by demonstrating that current mortality experience of the affected block(s) of business exceeds pricing assumptions when the policies were sold.